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# Immigration Law and the Regulation of Marriage

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## Article

# Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes

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## INTRODUCTION

Months after insurance giant American International Group (AIG) faltered and the federal government provided financial assistance to keep the company afloat,<sup>1</sup> executive compensation and bonus practices at the company came under scrutiny.<sup>2</sup> Taxpayers balked when evidence came to light that

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1. See William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. (forthcoming 2009) (manuscript at 14–29), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1346552](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552) (describing the circumstances surrounding AIG's near-bankruptcy and the subsequent bailout). Various sources have been tracking the recipients of government bailout money. See, e.g., Matthew Ericson et al., *Tracking the \$700 Billion Bailout*, N.Y. TIMES, June 24, 2009, <http://projects.nytimes.com/creditchrisis/recipients/table>; ProPublica, *Eye on the Bailout*, <http://bailout.propublica.org/main/list/index> (last visited Nov. 8, 2009).

2. See, e.g., Deborah Solomon, *Uproar Over Geithner's Role in Bonuses Could Vex Rescue*, WALL ST. J., Mar. 19, 2009, at A5 (reporting that AIG paid out \$165 million in bonuses after the company received bailout funds).

large bonuses were being paid to executives—the same executives, in certain instances, who had been responsible for AIG’s losses.<sup>3</sup> The disconnect between AIG’s huge losses and the multi-million dollar bonus payments is a striking example of “pay without performance,” a phenomenon that Professors Jesse Fried and Lucian Bebchuk documented in their book of the same name.<sup>4</sup> Responding to public outrage,<sup>5</sup> the House of Representatives sought to impose a retroactive marginal taxation rate of ninety percent on the AIG bonuses (as of the date of this writing, the bonus tax had passed in the House of Representatives, but not the Senate).<sup>6</sup> During the debate over the bonus

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3. See Randall Smith & Liam Plevin, *Some Will Pay Back AIG Bonuses*, WALL ST. J., Mar. 19, 2009, at A1 (reporting that certain members of AIG’s Financial Products group—responsible for a great deal of the losses—had received bonuses, but that some, under mounting public pressure, had decided to repay them).

4. LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 15–41 (2004) (suggesting that in the absence of arm’s-length bargaining between directors and executives, executive performance and compensation have become unlinked).

5. See, e.g., John Christoffersen, *AIG Execs’ Lavish Homes Draw Busload of Activists*, SEATTLE TIMES, Mar. 22, 2009, at A4 (discussing middle-class protestors who visited executives’ homes in hopes of convincing them to share their wealth); Michael M. Phillips, *Outrage Overflows on Capitol Hill as Lawmakers Denounce Bonuses*, WALL ST. J., Mar. 19, 2009, at A4 (“Members of the House . . . mentioned their outrage at . . . [AIG] 18 times . . . . And that was during 45 minutes of opening remarks, even before the immediate target of their outrage, AIG Chief Executive Edward M. Liddy, entered the room.”); Liam Plevin et al., *AIG Faces Growing Wrath over Payouts*, WALL ST. J., Mar. 16, 2009, at A1 (“Troubled insurer American International Group Inc., now [eighty percent] owned by U.S. taxpayers, spent the weekend deflecting mounting criticism of how government funds have been . . . used to pay employee bonuses at the business unit that almost sank the company.”); Jonathan Weisman et al., *Treasury Will Make Grab to Recoup Bonus Funds*, WALL ST. J., Mar. 18, 2009, at A1 (quoting Republican Senator Charles Grassley as saying that AIG’s managers should “take that deep bow and say ‘I’m sorry’ and then either do one of two things: resign or go commit suicide.”).

6. See *To Impose an Additional Tax on Bonuses Received from Certain TARP Recipients*, H.R. 1586, 111th Cong. (2009); see also Greg Hitt & Aaron Lucchetti, *House Passes Bonus Tax Bill*, WALL ST. J., Mar. 20, 2009, at A1 (describing the House bill as an echo of “popular outrage over big payouts to employees of [AIG]”). As of the time of this writing, the bonus tax is still being considered, but no action has been taken in the Senate. See *infra* Part I.B.2. The legality of such a tax is questionable, not only because of its retroactive nature, but also because targeting specific companies and individuals creates potential constitutional issues, including bill of attainder concerns. Although the constitutional issues are interesting in their own right (and the later portion of the Article attempts some preliminary analysis)—they are not our main focus. See *infra* note 75 and accompanying text. Instead, we are more con-

tax, both legislators and media alike described the pending bill as a “clawback” provision.<sup>7</sup>

The same term—“clawback”—has been used to refer to remedies potentially available to defrauded investors in a Ponzi scheme.<sup>8</sup> For over a decade, the former director of NASDAQ, Bernard Madoff, had been pretending to operate a hedge fund that turned out to be one immense house of cards.<sup>9</sup> The fraud robbed investors, including some charitable institutions, of billions of dollars<sup>10</sup> and created a crisis of confidence in the capital markets.<sup>11</sup> In Madoff’s fund, there was in reality no investment strategy to provide “hedges” against typical forms of risk. Indeed, there did not even appear to have been any trading of stock for over a decade.<sup>12</sup> Rather, as in a textbook Ponzi scheme, the early investors were bought off with the money

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cerned with writing clawback provisions into contracts prospectively and examining the consequences of their inclusion on contract law.

7. See, e.g., Michael O’Neal, *AIG Tumult Eroding Confidence*, CHI. TRIB., June 11, 2009, at A15 (“The bill seeks to claw back bonuses . . .”). In the intervening months, other developments, including the appointment of Kenneth Feinberg as Special Master or “Compensation Czar” for TARP recipients, and the focus on passing a “Say on Pay” shareholder vote have taken more central places in the government’s policy toward executive compensation. See Press Release, U.S. Dep’t of Treasury, Interim Final Rule on TARP Standards for Compensation and Corporate Governance (June 10, 2009), <http://www.treas.gov/press/releases/tg165.htm> [hereinafter TARP Standards Press Release] (announcing the new Treasury Department rules capping CEO pay for companies receiving TARP funds); Press Release, U.S. Dep’t of Treasury, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), <http://www.treas.gov/press/releases/tg163.htm> [hereinafter Geithner Statement Press Release] (laying out the principles underlying the Treasury Department’s compensation restrictions); see also Louise Story & Stephen Labaton, *Overseer of Big Pay Is Seasoned Arbitrator*, N.Y. TIMES, June 11, 2009, at B1 (describing the “almost unprecedented discretion” of the Compensation Czar to set compensation levels). For a further discussion of current developments, see *infra* Part I.B.1.

8. See, e.g., Jane J. Kim, *As ‘Clawback’ Suits Loom, Some Investors Seek Cover*, WALL ST. J., Mar. 12, 2009, at C3 (“Investors who lost money with financier Bernard Madoff are girding for potential ‘clawback’ suits that might be brought by the trustee in charge of liquidating Mr. Madoff’s firm.”).

9. Some estimates place investor losses at nearly \$65 billion. See Aaron Lucchetti & Tom Lauricella, *Investors Were Told They Had a Total of \$64.8 Billion*, WALL ST. J., Mar. 11, 2009, at A2.

10. See *id.*

11. See, e.g., Robert Frank et al., *Madoff Jailed After Admitting Epic Scam*, WALL ST. J., Mar. 13, 2009, at A1 (“Mr. Madoff’s decline and fall added to a national crisis of confidence and distrust of the financial system.”).

12. See, e.g., Amir Efrati & Robert Frank, *Madoff Set to Plead Guilty to 11 Felonies*, WALL ST. J., Mar. 11, 2009, at A1 (“A court-appointed trustee has found that no trading occurred for more than a decade.”).

from the later investors.<sup>13</sup> In turn, the payouts to the early investors were relied upon as proof of profitability to convince later investors that returns were legitimate. Because Madoff and his “hedge fund” are now insolvent, the question has arisen as to whether the bankruptcy trustee may bring a “clawback” action on behalf of the later investors to recover the profits of the early investors.<sup>14</sup>

In recent months, Congress, the media, and other commentators have all employed the term “clawback” to describe a stunningly broad variety of contractual provisions, legislative enactments, and legal remedies.<sup>15</sup> This leads to a series of questions surrounding so-called clawback provisions. First, what constitutes a “clawback”?<sup>16</sup> Are the provisions in the bailout law dealing with AIG or the remedies in Ponzi schemes “clawbacks,” or something else entirely? Why are the current remedies in these contexts inadequate?<sup>17</sup> Why are these retroactive remedies so difficult to implement under current law? Going forward, how might prospective inclusion of clawback provisions and a robust interpretation of those provisions be desirable? What effect would clawback provisions have on other matters of well-settled contract doctrine that deal with allocation of risk?<sup>18</sup> This Article aims to provide a framework for answering these questions, while using current situations at the forefront of the current financial crisis as salient examples. Specifically, we discuss executive compensation, as highlighted in the cases of AIG and Merrill Lynch, and Ponzi schemes, as illustrated by the multi-billion dollar fraud in the Madoff hedge fund, both of which involve the controversial effort to impose clawbacks retroactively.

In this Article, we explore and develop the doctrine of clawbacks. We define “clawback” as a theory for recovering benefits that have been conferred under a claim of right, but that are nonetheless recoverable because unfairness would oth-

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13. See, e.g., Tom Lauricella et al., *Madoff Used U.K. Office in Cash Ploy, Filing Says*, WALL ST. J., Mar. 12, 2009, at C1 (describing criminal charges against Madoff).

14. See Kim, *supra* note 8.

15. See, e.g., *supra* notes 7–8 and accompanying text; see also *infra* notes 205, 207–08.

16. The term “clawback” has been used in a somewhat casual way to describe any effort at recoupment of losses. In Part III of the Article we discuss a more precise definition of the term in greater detail. See *infra* Part III.

17. See *infra* Part III.B.

18. See *infra* Part III.C.

erwise result. This definition includes both *retroactive* clawbacks—those that, like the (pending) ninety percent tax on bonuses, are imposed after the contractual right to the bonuses has arisen and the benefits have been conferred—and *prospective* clawbacks that are introduced into contracts before the claim of right to the benefits has arisen. For example, some companies, like Dell, are prospectively writing provisions into their executive compensation contracts that would recover or cancel bonus awards in the event that the company must restate its financial results.<sup>19</sup>

As we will explain further, the structure of clawbacks indicates that they operate more effectively if they are prospective, rather than retroactive. Accordingly, we suggest writing prospective clawback terms into contracts directly, or implying them through default rules where possible, for example through potential amendments to the law of securities regulation.

The Article begins, in Part I, with a discussion of clawback provisions in executive compensation contracts. Part II moves to examine clawback clauses in the context of Ponzi schemes, primarily through a study of the Madoff hedge fund fraud. Next, Part III draws these strands together by discussing the definition of clawbacks, as well as the doctrinal implications of clawback clauses within the panoply of contractual remedies. Ultimately, we make the argument that clawback clauses will be an effective measure to avoid some of the predicaments in which shareholders and investors are currently embroiled.

## I. CLAWBACK PROVISIONS AND EXECUTIVE COMPENSATION

Excessive executive compensation in United States companies has long been a problematic corporate governance issue,<sup>20</sup> and one that despite many reform proposals has been seemingly resistant to change.<sup>21</sup> From an international perspective, the

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19. See *infra* Appendix, Part C.

20. Much of the case law on everything from fiduciary duty to shareholder voting has arisen out of disputes over executive compensation. See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 552–57 (1949) (affirming the applicability of New Jersey shareholder litigation law over a shareholder dispute regarding managerial compensation); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 47–51, 68–73 (Del. 2006) (holding that a \$130 million severance package did not violate the board's or the president's fiduciary duty to shareholders).

21. BEBCHUK & FRIED, *supra* note 4, at 1 (noting that the gap between

United States has a larger discrepancy between the amount paid to top executives and the average worker than many countries in Europe.<sup>22</sup> While there has been much concern about the problem of excessive executive compensation—from both corporate governance and social equality perspectives<sup>23</sup>—and there has been much discussion about potential solutions,<sup>24</sup> the problem remains unsolved. The following Section provides a brief overview of the issues, then moves to examine the compensation debate that has arisen specifically in the context of the bailout, and then proposes prospective clawback provisions as a potentially effective response to a long-standing conundrum.

#### A. BRIEF OVERVIEW OF EXECUTIVE COMPENSATION

Part of the concern with executive compensation is that the amount of payment involved is often contingent, difficult to value, or, at times, not fully transparent. Many publicly traded companies provide a large portion of compensation in company stock or stock options, which have uncertain valuation.<sup>25</sup> Other companies have a large portion of compensation awarded in year-end bonuses, while others utilize deferred compensation such as pension obligations. Still others reward executives with particular perks, such as use of the company jet, club memberships, or other fringe benefits.

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executive pay and that of average workers continues to expand despite attention to the issue by the public and regulators).

22. See Richard A. Posner, *Are American CEOs Overpaid, and if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1020–25 (2009) (stating that American CEOs are paid, on average, about twice as much as their foreign counterparts). This discrepancy may be a result of the comparatively larger role of labor in the foreign corporate governance process. Some figures, circa 2003, seem to put the gap at five hundred times that of the average worker. See SAMUEL ESTREICHER & MIRIAM A. CHERRY, GLOBAL ISSUES IN EMPLOYMENT LAW 202 (2008); *CEOs and Their Indian Rope Trick*, THE ECONOMIST, Dec. 11, 2004, at 61 (arguing that between 1991 and 2003 the pay differential between executives and workers more than tripled, and by 2003 “was over 500 times, and growing”).

23. See, e.g., Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. SCH. L. REV. 585, 586 (2007–2008) (describing both corporate governance and social equality concerns).

24. See, e.g., Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 920–25 (2007) (examining provisions of the tax code enacted in 1993 intended to limit excessive compensation and concluding that these provisions have actually resulted in increased costs to shareholders).

25. See, e.g., *Seinfeld v. Bartz*, No. C01-2259, 2002 WL 243597, at \*3–4 (N.D. Cal. Feb. 8, 2002) (discussing the valuation of stock options).

Yet another form of compensation that has proven to be controversial is the so-called golden parachute, a payment to the executive that is typically triggered in the event of a change of control in the corporation.<sup>26</sup> The ostensible reason to adopt golden parachutes is to align the interest of the management with shareholders' interests—otherwise, incumbent management might resist an acquisition for the purpose of perpetuating their own tenure.<sup>27</sup> However, in the vivid words of one commentator, golden parachutes conjure the “image of a laughing executive landing softly with oodles of misappropriated corporate assets while his corporation goes down in flames.”<sup>28</sup> Looked at with skepticism as a payoff to existing management at the expense of shareholders, these payments have largely been regulated by unfavorable tax treatment in the Internal Revenue Code.<sup>29</sup>

### 1. A Theory of Maximum Wages: Managerial Power

In the introduction to this Article, we mentioned the influential work of Professors Lucian Bebchuk and Jesse Fried, who have extensively studied different forms of CEO pay and who have ultimately concluded that widely used incentive-based payments have failed to deliver on their promise of performance.<sup>30</sup> Excessive pay packages in corporations with diffuse ownership have typically been seen as a classic agency prob-

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26. See, e.g., Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 957–60 (1987) (analyzing the policy reasons for adopting such contractual provisions); Albert Choi, *Golden Parachute as a Compensation-Shifting Mechanism*, 20 J.L. ECON. & ORG. 170, 170–71 (2004) (discussing the function of golden parachutes and introducing some critiques).

27. See, e.g., *Cheff v. Mathes*, 199 A.2d 548, 554–55 (Del. 1964) (explaining that struggles for corporate control create potential conflicts of interest between shareholders and executives).

28. Bress, *supra* note 26, at 960.

29. See I.R.C. § 280G (West Supp. 2009) (making golden parachutes non-deductible for the payor corporation); I.R.C. § 4999 (2006) (imposing a twenty percent excise tax on golden parachutes); see also Jamie Dietrich Hankinson, *Golden Parachute Tax Provisions Fall Flat: Tax Gross-Ups Soften Their Impact to Executives and Square D Overinflates Their Coverage*, 34 STETSON L. REV. 767, 770–71 (2005) (describing the tax penalties on excess parachute payments, and mentioning the possibility that costs for such tax penalties will merely be shifted back onto shareholders).

30. See BEBCHUK & FRIED, *supra* note 4, at 121–85 (arguing that many incentive-based forms of compensation are susceptible to a decoupling of pay from performance); see also Lucian Bebchuk & Jesse Fried, *Equity Compensation for Long-Term Results*, WALL ST. J., June 16, 2009, <http://online.wsj.com/article/SB124516105628518981.html> (advocating tying executive compensation to long-term rather than short-term metrics).



lem<sup>31</sup>—the difficulty a largely passive group of shareholders has in monitoring the actions of the firm's managers. Professors Bebchuk and Fried take the argument further, arguing that excessive compensation packages have their origin in the reluctance of directors to hold executives accountable for their performance, due to a structural bias among those who comprise boards of directors and management of corporations.<sup>32</sup> Their "managerial power" critique speaks to deep structural flaws inherent in the separation of ownership and control in corporations.<sup>33</sup>

## 2. Legal Landscape

The issue of executive compensation has mostly been addressed in the same way many other corporate governance issues have been—through a fundamental federal dualism.<sup>34</sup> The first layer of regulation consists of state law, operating through state corporate statutes that constrain boards of directors through the doctrine of fiduciary duty, and at the law's outer limits, the doctrine of corporate waste.<sup>35</sup> The second layer of regulation emerges through the federal laws governing the publicly held corporation, which focus on disclosure, transparency, and informed investor choice.<sup>36</sup>

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31. See, e.g., ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 64 (Harcourt, Brace & World, Inc. 1968) (1932) (discussing the shift from active to passive agency and the resulting powerlessness of modern shareholders).

32. See BEBCHUK & FRIED, *supra* note 4, at 23–44 (arguing that social and structural factors weaken the independence of corporate boards); see also Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2035–52 (2007) (explaining how "groupthink" leads to suboptimal outcomes among decision-makers with respect to executive compensation).

33. See BEBCHUK & FRIED, *supra* note 4, at 45–58 (arguing that market forces alone are insufficient to align ownership and management interests).

34. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478–79 (1977) (discussing the differences in approaches between state and federal corporate regulation).

35. See Robert C. Art, *Shareholder Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations*, 28 J. CORP. L. 371, 372–74, 384–90 (2003) (discussing "fiduciary duty" and "reasonable expectation" analyses across jurisdictions, with particular attention to Oregon corporate law). See generally John W. Murrey, III, *Excessive Compensation in Publicly Held Corporations: Is the Doctrine of Waste Still Applicable?*, 108 W. VA. L. REV. 433, 435–41, 453–57 (2005) (exploring the evolution of the corporate waste doctrine under Delaware law).

36. See Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 450 (2002) ("At its core, the

Unfortunately, these dual approaches have not been particularly successful at curbing excessive compensation packages.<sup>37</sup> Undoubtedly, one reason that this might be so is that complete and accurate information on executive pay has not been publicly available, despite the ostensible disclosure regime.<sup>38</sup> Although the Sarbanes-Oxley Act did not address executive compensation directly,<sup>39</sup> the law did contain provisions that would allow the Securities and Exchange Commission (SEC) to freeze assets for extraordinary payments, which could be applied to freeze executives' golden parachutes in the instance of fraud.<sup>40</sup> Public companies were no longer allowed to provide personal loans to management or other insiders—a form of “hidden” compensation.<sup>41</sup> In certain circumstances, section 304 of the Sarbanes-Oxley Act empowers the SEC to bring an action to recover money from executives to blame for a fraud.<sup>42</sup> However, this provision (the so-called Sarbanes-Oxley clawback) has been largely ignored, with the SEC bringing only two enforcement actions in the seven years Sarbanes-Oxley has

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primary policy of the federal securities laws involves the remediation of information asymmetries, that is, equalization of the information available to outside investors and insiders.”).

37. See, e.g., Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481, 490–507 (2007) (describing gaps left by the different approaches taken in federal and state regulation of executive compensation); Mary-Hunter Morris, *The Price of Advice*, 86 U. DET. MERCY L. REV. 153, 154–56 (2009) (arguing that compensation consultants contribute to the problem of excess executive compensation).

38. See, e.g., John D. Shipman, *The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules*, 85 N.C. L. REV. 1194, 1194–95 (2007) (describing how the complex nature of executive pay and disclosure disguises the true value of compensation).

39. For a general description and analysis of the provisions of the Sarbanes-Oxley Act, see Miriam A. Cherry, *Whistling in the Dark? Corporate Fraud, Whistleblowers, and the Implications of the Sarbanes-Oxley Act for Employment Law*, 79 WASH. L. REV. 1029, 1055–69 (2004).

40. See SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1045–46 (9th Cir. 2004) (en banc) (holding that golden parachutes are “extraordinary” payments and thus fall under the purview of the clawback provision); Stephanie Francis Ward, *SEC Can Seize CEO Payouts*, 4 ABA J. E-REPORT 13, Apr. 1, 2005 (explaining the significance of the Gemstar ruling).

41. See Sarbanes-Oxley Act § 402(a), 15 U.S.C. § 78m(k) (2006).

42. See Sarbanes-Oxley Act § 304(a), 15 U.S.C. § 7243(a) (2006); Litigation Release No. 20387, U.S. Sec. and Exch. Comm'n, Former United Health Group CEO/Chairman Settles Stock Options Backdating Case for \$468 Million (Dec. 6, 2007), <http://www.sec.gov/litigation/litreleases/2007/lr20387.htm> (announcing a settlement with William W. McGuire, former CEO of UnitedHealth Group, following an enforcement action under section 304).

been in effect.<sup>43</sup> As with any law, the Sarbanes-Oxley Act is only as powerful as its implementation and enforcement.

Unsurprisingly, then, the Sarbanes-Oxley reforms did not fix the broken components of executive compensation.<sup>44</sup> The 2006 option-backdating scandal demonstrated that many of the problems with executive compensation remained unresolved.<sup>45</sup> Stock options are ostensibly incentive payments that are tied to a rise in the company's stock price. In the backdating scandal, however, companies retroactively adjusted the date of grant of the options to a date on which the stock price was comparatively low.<sup>46</sup> With the benefit of hindsight, the options were guaranteed to be "in the money."<sup>47</sup> Instead of incentive pay that would align the executives' interests (and involved risk) with that of the shareholders, backdated options became guaranteed

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43. See Linda Chatman Thomsen & Donna Norman, *Sarbanes-Oxley Turns Six: An Enforcement Perspective*, 3 J. BUS. & TECH. L. 393, 408 (2008) (explaining that the SEC has brought only two enforcement actions under this provision); see also Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 2 (2008) (explaining that only the SEC can bring suit under section 304 of the Sarbanes-Oxley Act).

44. See, e.g., Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints*, WALL ST. J., Oct. 12, 2006, at A1 (arguing that despite an initial drop in average compensation following Sarbanes-Oxley, golden parachutes and other types of compensation have increased executive pay).

45. For an in-depth discussion of the option backdating scandal, see Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 857–58 (2008) (listing types of backdating and suggesting that such "secret" compensation arrangements reinforce excessive managerial influence over boards of directors); see also Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 468–74 (2008) (suggesting prearranged trading plans as a way to sidestep managerial exploitation of option grants).

46. See David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 564 (2007).

Although option valuation is complex, at one level the backdating story is simple. Imagine that on March 15 the stock of Tech Inc. closes at \$50/share. An option on Tech granted on that date would normally have an exercise price of \$50/share. Granting the option 'at the money' ensures that the recipient profits only if the shares appreciate in value and the shareholders profit. But imagine that the CEO of Tech looks back and notices that on February 15 the company's stock price was only \$40/share. By falsifying the paperwork to make it appear that the company granted him an at-the-money option on February 15, when in fact the option was granted on March 15, the CEO has effectively acquired an option that is 'in the money' by \$10/share.

*Id.*

47. See Shipman, *supra* note 38, at 1200–18 (describing option backdating and the reforms adopted in response to the scandal, which the author characterizes as largely ineffectual).

payments.<sup>48</sup> As the adjustments were never disclosed to investors in periodic filings as they should have been, the SEC investigated over one hundred companies for engaging in the practice.<sup>49</sup> In the aftermath of the backdating scandal, the SEC promulgated a series of regulations to govern disclosure of the value of executive pay. Most notably, the SEC required that an accurate and extremely detailed valuation of the top executives' compensation packages, including options and bonuses, be provided as part of the periodic filings required of publicly traded companies under the 1934 Securities and Exchange Act.<sup>50</sup> In sum, the response to the option backdating scandal has been increased federal government regulation. Not all, however, would agree that that the issue of excessive executive compensation merits a similar response.

### 3. Counterarguments and Rebuttal

Those who believe in less government intervention might reply that these compensation packages are the result of an efficient market.<sup>51</sup> If corporations need to pay well in order to recruit the best talent, they should be allowed to do so, perhaps cabined in extreme circumstances by the state law doctrine of corporate waste.<sup>52</sup> In certain circumstances, a high degree of

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48. See Walker, *supra* note 46, at 564.

49. See *id.* at 562 (examining the extent of the scandal).

50. For a general description of these rules, see Sean M. Donahue, *Executive Compensation: The New Executive Compensation Disclosure Rules Do Not Result in Complete Disclosure*, 13 FORDHAM J. CORP. & FIN. L. 59, 61 n.3 (2008) (citing to the relevant executive compensation disclosure rules); Leigh Johnson et al., *Preparing Proxy Statements Under the SEC's New Rules Regarding Executive and Director Compensation Disclosures*, 7 U.C. DAVIS BUS. L.J. 373, 378–98 (2007) (describing proxy disclosure rules in detail); Kenneth M. Rosen, "Who Killed Katie Couric?" and Other Tales from the World of Executive Compensation Reform, 76 FORDHAM L. REV. 2907, 2910–23, 2940 (2008) (providing a detailed discussion of administrative rulemaking around SEC disclosure rules for executive compensation).

51. See, e.g., John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1172–79 (arguing that executive compensation is aligned with performance through equity holdings and stock options); M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation when Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1618 (2007) (contending that compensation arrangements in bankruptcy result in similarly large pay packages, which potentially disproves the managerial power thesis).

52. See *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 74 (Del. 2006) (noting that corporate waste only arises in the rare, "unconscionable case where directors irrationally squander or give away corporate assets") (citation omitted). Although the standard that a plaintiff shareholder has to

skill could provide a huge benefit, whether in a competitive sport or in a business context.<sup>53</sup> Additionally, one could argue that there is a market for executive services, and that it is appropriate to adopt the prevailing wage for a particular skill set.<sup>54</sup>

In light of recent events, however, even Judge Richard Posner has, albeit reluctantly, come to the view that executive overcompensation is problematic.<sup>55</sup> Instead of tying compensation to the success of the company, it would appear that in some circumstances executives sought to profit regardless of the outcome, and that even in the wake of near insolvency, protected themselves through contractual provisions. While golden parachutes for executives have long been part of the backdrop of corporate America,<sup>56</sup> this burden has been borne by shareholders (who preserve the ability to exit), rather than the public at large. However, as taxpayers have come to realize, excessive pay practices have now been foisted upon them through the mechanism of the financial bailouts.

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meet in alleging corporate waste under *Disney* is extremely high, there is some hint that the doctrine of waste may be making a comeback in Delaware. Specifically, the shareholder complaint in the *Citibank* case has moved forward in part on this basis. See *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009) (allowing waste claim to survive a motion to dismiss when "the Company paid the multi-million dollar compensation package to a departing CEO whose failures were allegedly responsible, in part, for billions of dollars of losses at Citigroup").

53. See, e.g., Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1619, 1626–61 (2005) (noting the market for various services including professional basketball players, and arguing for caution in reforming executive compensation).

54. For example, in *Disney*, Michael Ovitz was earning "approximately \$20 to \$25 million a year" as the head of Creative Artists Agency. *In re Walt Disney*, 906 A.2d at 37. While his compensation package at Disney was enormous, that pay package did not look unreasonable compared to his earnings and holdings at Creative Artists. See *id.* (describing Ovitz's compensation package negotiations at Disney).

55. See Posner, *supra* note 22, at 1014, 1045–46 (stating that the executive compensation problem is "more serious than I believed it to be" and listing quick responses to principal-agent problems inherent in the corporate form).

56. These practices continue to date. Although a recent study of proxy statements filed between October 2008 and March 2009 indicates that CEO pay fell "for only the second time in the past two decades," a number of publicly traded companies provided lavish bonuses to their executives—despite deep losses or a lack of return on equity. See Phred Dvorak, *Poor Year Doesn't Stop CEO Bonuses*, WALL ST. J., Mar. 18, 2009, at B1.

## B. EXECUTIVE COMPENSATION AND CLAWBACKS IN THE GOVERNMENT BAILOUTS

### 1. Legal Landscape for Bonuses in the Bailout

In the past months, much attention has focused on the payout of bonuses at companies accepting funds under the government's Troubled Asset Relief Program (TARP), the proposed (still pending) tax on those bonuses, the later appointment of Kenneth Feinberg as Special Master ("Compensation Czar"), and the urging of the Obama Administration that Congress pass a non-binding shareholder "Say on Pay" law for all publicly held companies.<sup>57</sup> The various Congressional mandates, Treasury Department interim rules, and executive pronouncements concerning executive compensation are complex, technical, and largely constitute compromise measures.<sup>58</sup>

Title VII of the American Recovery and Reinvestment Act of 2009 ("2009 Recovery Act") is aimed at providing aid to large industries in order to curb the financial crisis.<sup>59</sup> As part of its

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57. See Geithner Statement Press Release, *supra* note 7; TARP Standards Press Release, *supra* note 7; see also Sarah N. Lynch, *Treasury Explains Why Only 7 Firms Must Answer to Compensation Czar*, DOW JONES NEWSWIRE, June 11, 2009, <http://www.nasdaq.com/aspx/company-news-story.aspx?storyid=200906111227dowjonesdjonline000767> (noting that "seven big financial firms that received bailouts will be subject to heightened oversight of their compensation" by Kenneth Feinberg); Louise Story & Eric Dash, *Treasury Plans Wider Oversight of Compensation*, N.Y. TIMES, June 8, 2009, at A1 (outlining the Obama administration's plans to monitor executive pay compensation for bailout companies); Cari Tuna & Joann S. Lublin, *New Pay Guidelines Raise Questions*, WALL ST. J. ONLINE, June 10, 2009, <http://online.wsj.com/article/SB124467682643104143.html> (analyzing the new pay guidelines put forth by the Obama administration).

58. See, e.g., Deborah Solomon & Mark Maremont, *Bankers Face Strict New Pay Cap*, WALL ST. J., Feb. 14, 2009, at A1. Apparently, several economists within the Obama administration expressed the countervailing concern that too many restrictions on executive pay might prevent banks from accepting bailout funds, even if it meant that the credit crisis would continue. See *id.*

59. See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, div. B, tit. VII, § 7001, 123 Stat. 115, 516-20 (amending the Emergency Economic Stabilization Act of 2008 § 111, 12 U.S.C.A. § 5221 (West Supp. 2009)) (setting forth guidelines that a company must follow to receive bailout funds). For an analysis of the financial crisis, its causes, and the subsequent bailouts, see Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 376 (2008) ("Most of the causes . . . can be attributed to conflict of interest, investor complacency, and overall complexity, all exacerbated by cupidity."). See also Steven M. Davidoff & David T. Zaring, *Big Deal: The Government's Response to the Financial Crisis* 3 (Nov. 24, 2008) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1306342](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1306342) (describing the gov-

provisions, the 2009 Recovery Act specifically details limitations on executive compensation in companies that accept government TARP funds.<sup>60</sup> The 2009 Recovery Act states that the Secretary of the Treasury shall require each bailout recipient “to meet appropriate standards for executive compensation and corporate governance.”<sup>61</sup> Critically, the statute requires a “provision for the recovery . . . of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next [twenty] most highly-compensated employees . . . based on [financial results] that are later found to be materially inaccurate.”<sup>62</sup> It also prohibits “making any golden parachute payment to a senior executive officer or any of the next [five] most highly-compensated employees” so long as “any obligation arising from financial assistance [in the bailout] . . . remains outstanding.”<sup>63</sup> A separate subheading limits “luxury expenditures,”<sup>64</sup> which may include “entertainment or events,” “office and facility renovations,” “aviation or other transportation services” or the catchall category of “other activities or events that are not reasonable expenditures.”<sup>65</sup> Finally, the section ends by establishing a “Say on Pay,” which requires disclosure of executive compensation and then a non-binding shareholder vote on the executive compensation package.<sup>66</sup>

The most conflicted and troubling portion of the 2009 Recovery Act, however, is that in listing the prohibitions on executive compensation, previous bonuses that were awarded are expressly exempted from any limitations.<sup>67</sup> Specifically, the law states that the prohibition on awards of bonuses or restrictive stock “shall not be construed to prohibit any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009, as such valid em-

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ernment’s \$700 billion asset purchase program as a “massive investment” in the country’s largest financial institutions, and a “partial nationalization which the United States had never seen before”).

60. See American Recovery and Reinvestment Act of 2009, § 7001 (outlining limitations on executive compensation).

61. *Id.* (amending the Emergency Economic Stabilization Act of 2008 § 111(b)(2)).

62. *Id.* (amending § 111(b)(3)(B)).

63. *Id.* (amending § 111(b)(3)(C)).

64. *Id.* (amending § 111(d)).

65. *Id.* (amending § 111(d)(1)–(4)).

66. See *id.* (amending § 111(e)(1)–(2)).

67. See *id.* (amending § 111(b)(3)(D)(iii)).

ployment contracts are determined by the Secretary or the designee of the Secretary.”<sup>68</sup>

## 2. Retroactive Application of the Laws to AIG Bonuses

A brief discussion of how these provisions relate to the AIG bonuses may be instructive. As referenced in the introduction, the House of Representatives passed legislation to tax a number of the AIG bonuses at a ninety percent rate, but that bill has not been passed by the Senate.<sup>69</sup> The pending bill faced various legal obstacles—one of which, as explained in the previous Section, was that Congress had seemingly acquiesced in these very same bonus payments only a month earlier in the 2009 Recovery Act.<sup>70</sup> It seems clear that the government had several opportunities to ensure that excessive bonuses were not paid but unfortunately failed to act.<sup>71</sup> Notwithstanding, it is curious that AIG seemed to rush to pay bonuses,<sup>72</sup> when the board of directors might have had valid legal arguments that

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68. *Id.*

69. See To Impose an Additional Tax on Bonuses Received from Certain TARP Recipients, H.R. 1586, 111th Cong. § 1(a)(2) (2009).

70. See American Recovery and Reinvestment Act of 2009 § 7001 (amending the Emergency Economic Stabilization Act of 2008 § 111(b)(3)(D)(iii)). An earlier version of the bill had much more serious restrictions, which gave the company a choice of forfeiting the bonuses or charging the company a high tax rate. See Jonathan Weisman, *Dodd's Amendment at Crux of Bonus Issue*, WALL ST. J., Mar. 19, 2009, at A4. In providing the choice, Congress might have avoided the retroactivity problem. Unfortunately those parts of the bill were eliminated, and now members of Congress are blaming each other for its erasure. See *id.*

71. See Solomon, *supra* note 2 (“Administration officials say they didn’t have enough time to deal with bonuses before AIG . . . [paid them]. They say [Treasury Secretary] Geithner learned of the payments on March 10—just a few days after the Treasury loaned another \$30 billion to AIG.”).

72. Among the justifications for paying out the bonuses was AIG CEO Liddy’s fear that the company would be assessed legal penalties under Connecticut labor laws for withholding employee wages. See Letter from Edward M. Liddy, Chief Executive Officer, Am. Int’l Group, Inc., to Timothy F. Geithner, U.S. Sec’y of the Treasury (Mar. 14, 2009), <http://www.ft.com/cms/5a06cc90-118d-11de-87b1-0000779fd2ac.pdf>; see also AIGFP EMPLOYEE RETENTION PLAN, EXECUTIVE SUMMARY 2–3 (2009), <http://www.scribd.com/doc/13291401/AIGFP-Employee-Retention-Plan>. However, the Attorney General of Connecticut expressed doubt about AIG’s interpretation. See David G. Savage, *Doing the Math on AIG Bonuses*, L.A. TIMES, Mar. 22, 2009, at A3 (quoting Connecticut Attorney General Richard Blumenthal in saying: “AIG was categorically wrong when it claimed that state labor law compelled payments of these outrageous, unconscionable bonuses,” and further that the Connecticut law requiring double payment for a failure to pay wages “does not apply to AIG bonuses” and was “a joke of a justification to reward financial failure and fiasco”).



there were defenses to such payment.<sup>73</sup> Nonpayment would have forced the executives to bring suit against AIG, at the very least providing the company with some delays, a respite from the scandal, and perhaps given Congress a chance to respond.<sup>74</sup>

There are further legal concerns with the pending bonus tax bill. Its narrow focus on particular companies and executives may raise a concern about whether it constitutes an unlawful bill of attainder.<sup>75</sup> All of these legal concerns about the bill, which without a doubt constitute factors in its lingering non-passage by the Senate, underscore how difficult it can be to attempt retroactive remedies in the bonus context.<sup>76</sup> That is not to say that arguments for recovery of these bonuses will be unsuccessful; but attempting to impose clawbacks retroactively through legislation is certainly not as efficient as including

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73. See Lawrence A. Cunningham, Op-Ed., *A.I.G.'s Bonus Blackmail*, N.Y. TIMES, Mar. 18, 2009, at A27 (listing a number of potential defenses to AIG's bonus payments, including defenses based on changed circumstances or fraudulent conveyance law) [hereinafter Cunningham, *Bonus Blackmail*]; see also Posting of Lawrence Cunningham to Concurring Opinions, [http://www.concurringopinions.com/archives/2009/03/aig\\_contract\\_qu.html](http://www.concurringopinions.com/archives/2009/03/aig_contract_qu.html) (Mar. 16, 2009, 14:42 EST). In his analysis, Professor Cunningham was careful to stress that any opinion about the legality of the contracts would need to start with the organic documents themselves. See *id.* ("It is important to see the contracts."). For the contracts themselves, see AIG Fin. Prods. Corp., 2008 Employee Retention Plan (Dec. 1, 2007), [http://www.house.gov/apps/list/press/financialsvcs\\_dem/employeeeretentionplan.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/employeeeretentionplan.pdf); AIG Fin. Prods. Corp., Schedule 1 to 2008 Employee Retention Plan, [http://www.house.gov/apps/list/press/financialsvcs\\_dem/confirmation\\_and\\_acknowledgement.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/confirmation_and_acknowledgement.pdf) (last visited Nov. 8, 2009).

74. See, e.g., Cunningham, *Bonus Blackmail*, *supra* note 73 (listing potential legal defenses that would excuse AIG from fulfilling its contractual obligations to pay employee bonuses).

75. See, e.g., Posting of Jonathan Adler to The Volokh Conspiracy, More on AIG Bonus Tax as Bill of Attainder, [http://volokh.com/archives/archive\\_2009\\_03\\_22-2009\\_03\\_28.shtml#1237734930](http://volokh.com/archives/archive_2009_03_22-2009_03_28.shtml#1237734930) (Mar. 22, 2009, 11:15 EST) (suggesting that the bonus tax bill was passed as a means of punishing "the ill-gotten gains" of AIG employees, and stating that "[w]hen Congress [confiscates property as punishment], it is a Bill of Attainder.").

76. Before obtaining an eighty percent equity stake, the Department of the Treasury should have insisted that both AIG and its executives abrogate all but a small portion of the bonus contracts as a condition of the investment. Without such a "rescue," the companies would have fallen into bankruptcy, which would have put the executives on equal footing with all of the company's other creditors. Faced with a worthless claim for millions in bonuses (or close to worthless, as they would receive little in the bankruptcy), the executives would likely have agreed to a reduced bonus amount. Cf. Davidoff & Zaring, *supra* note 59, at 20-41 (describing government policy in the bailout as a series of transactional "deals," wherein the government exhibited classic deal-making behavior by walking away from situations that were unfavorable).

clawback provisions organically within the body of the initial contract.

### 3. Bonuses at Merrill Lynch

The original recovery bill of fall 2008 established that if the Department of the Treasury received a “meaningful equity or debt position in the financial institution” then the recipient of the aid had to “meet appropriate standards for executive compensation” so long as the government remained a stakeholder.<sup>77</sup> However, in the wake of this bill, it came to light that many of the troubled companies had paid large bonuses to executives before their woes had arisen, others had actually moved up bonuses even after problems had started, and some companies were still contractually bound to provide golden parachutes to departing executives.<sup>78</sup> Estimates have varied wildly as to the amounts of the bonuses and the number of executives who received them.<sup>79</sup>

There have been allegations that in the wake of its poor performance and scheduled acquisition by Bank of America, Merrill Lynch actually moved up the schedule for payment of bonuses.<sup>80</sup> At the time of this writing, the New York Attorney General was examining the bonus structure and the timing of payments at Merrill Lynch in order to determine whether the company violated securities laws in the days leading up to the

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77. Emergency Economic Stabilization Act of 2008 § 111(b)(1), 12 U.S.C.A. § 5221 (West Supp. 2009).

78. See *infra* notes 80–82 and accompanying text.

79. See Gretchen Morgenson, *Gimme Back Your Paycheck*, N.Y. TIMES, Feb. 22, 2009, at BU1 (stating that the top executives at “troubled” American International Group, Bear Stearns, Citigroup, Countrywide Financial, Lehman Brothers, Merrill Lynch, and Washington Mutual received almost \$500 million in performance-based pay since 2005). For a full list of the companies receiving funds in the bailout, see ProPublica, *supra* note 1. However, the \$500 million figure seems suspiciously low compared to other reports. The AIG bonuses alone have been estimated at almost \$200 million, and the New York Attorney General’s Office has estimated that bonus payouts ranged in the billions. See *infra* note 81 and accompanying text; see also Cunningham, *Bonus Blackmail*, *supra* note 73 (describing the government’s recovery efforts regarding the “\$165 million in bonus payments the insurance giant A.I.G. recently made to nearly 400 employees”).

80. See, e.g., Letter from Andrew M. Cuomo, Attorney General of the State of N.Y. and Barney Frank, Chairman, House Fin. Servs. Comm. to Kenneth D. Lewis, Chief Executive & President, Bank of Am. Corp. (Mar. 9, 2009), available at [http://www.oag.state.ny.us/media\\_center/2009/mar/Letter%20to%20Kenneth%20Lewis%2003.09.09.pdf](http://www.oag.state.ny.us/media_center/2009/mar/Letter%20to%20Kenneth%20Lewis%2003.09.09.pdf) (alleging that “late last year [2008], Merrill Lynch moved up its planned date to allocate bonuses and then richly rewarded many of its executives”).

merger.<sup>81</sup> Filings by the Attorney General allege that these bonus payments were, in the aggregate, worth approximately \$3.6 billion and primarily went to enrich seven hundred of the top employees at Merrill Lynch.<sup>82</sup> Adding proverbial insult to injury, Merrill's then-CEO, John Thain, asked for an additional bonus at the end of what was a financially disastrous 2008 for the company.<sup>83</sup> After deliberation, the board of directors decided not to pay Thain the requested bonus because of the potential public outrage it might have engendered.<sup>84</sup> Although Thain apparently later withdrew his request in the wake of the board's opposition, the incident prompted further attention from the Attorney General's Office.<sup>85</sup>

#### 4. Analysis and Evaluation of Executive Compensation in the Bailout

By this point, it should be apparent that the 2009 Recovery Act's provisions regarding executive compensation are extremely problematic. Not only was the 2009 Recovery Act weak and ineffective in its provisions regarding limits on compensation, the law paradoxically *strengthened* the AIG executives' claim to the bonuses by exempting them from regulation.<sup>86</sup> The day af-

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81. See Susanne Craig, *Merrill's \$10 Million Men, Top 10 Earners Made \$209 Million in 2008 as Firm Foundered*, WALL ST. J., Mar. 4, 2009, at A1 ("New York Attorney General Andrew Cuomo has subpoenaed information about Merrill's highest-paid employees in connection with his probe into \$3.6 billion in bonuses paid by Merrill in the days before it was taken over by Bank of America Corp."); Susanne Craig & Dan Fitzpatrick, *Merrill Men Paid Over \$10 Million Subpoenaed*, WALL ST. J., Mar. 5, 2009, at C1 (noting that subpoenas were issued "to several top Merrill Lynch & Co. executives who were each paid more than \$10 million in cash and stock last year"); Dan Fitzpatrick, *Merrill Pay Scrutinized*, WALL ST. J., Mar. 18, 2009, at A2 (noting that the New York Attorney General is "conducting his own probe" into the Merrill Lynch bonuses).

82. See Letter from Andrew M. Cuomo, Attorney General of the State of N.Y., to the Honorable Barney Frank, Chairman, House Fin. Servs. Comm. (Feb. 10, 2009), available at [http://www.oag.state.ny.us/media\\_center/2009/feb/merrill%20letter.pdf](http://www.oag.state.ny.us/media_center/2009/feb/merrill%20letter.pdf).

83. See Susanne Craig, *Heat Turns Up on Merrill Bonuses' Timing*, WALL ST. J., Mar. 12, 2009, at C1 (providing conflicting accounts regarding Thain's request for a bonus); Louise Story, *Bonus Season Afoot, Wall Street Tries for a Little Restraint*, N.Y. TIMES, Dec. 9, 2008, at B1 (describing Thain's request for an additional \$10 million in bonus compensation).

84. See Story, *supra* note 83.

85. See *id.* (reporting that Cuomo wrote a letter in which he severely criticized the idea of additional performance bonuses for those at Merrill Lynch, calling such a request "a thumb in the eye to taxpayers").

86. See Mark Maremont & Joann S. Lublin, *Loopholes Sap Potency of Pay*

ter the 2009 Recovery Act was signed into law, “some critics identified weaknesses, suggesting the restrictions be retroactively applied to companies that already have received federal bailout cash.”<sup>87</sup> Other criticisms included the idea that the companies might give executives new titles in order to dodge the restrictions, and that the grants of restricted stock did not need to be tied to performance.<sup>88</sup> All of these weaknesses were brought into startling relief by the controversy surrounding the AIG bonuses.<sup>89</sup> As discussed above, there were many ways that the Treasury Department could have dealt with the bonus issue, but instead the situation was mishandled.<sup>90</sup>

Although it is not the focus of this Article, we present some options for addressing the problem that has been created—in a way that will pass constitutional muster. Public outrage, shaming, and pressure from elected officials (while not technically a legal remedy) are apparently having some effect on the AIG bonus recipients.<sup>91</sup> Another avenue would be to revisit the provision that allows the Secretary of the Treasury the ability to determine whether the bonus payments were made pursuant to “valid employment contracts.”<sup>92</sup> Between the strong public poli-

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*Limits*, WALL ST. J., Feb. 6, 2009, at C1.

87. *Id.*

88. *See id.*; see also Kate Kelly & David Enrich, *Wall Street Pursues Pay Loopholes*, WALL ST. J., Mar. 17, 2009, at C1.

89. *See* Weisman, *supra* note 70. In one version of the bill, Senators Wyden and Snowe advocated an amendment that would have capped bonuses at \$100,000 retroactive to 2008. *Id.* Bonuses paid in excess of that amount would have to be returned to the Treasury or taxed at a thirty-five percent rate. *Id.* While the Wyden-Snowe amendment passed in the Senate, it was dropped during House and Senate negotiations, amidst concerns that, by taxing 2008 income retroactively, it raised “constitutional objections.” *Id.* Nevertheless, “[i]ts authors argued that because companies were given a choice whether to return the bonuses or face a tax, the measure was not actually taxing past income but would ‘tax’ a company’s future decision—made with full knowledge of the consequences.” *Id.*

90. *See* Pleven et al., *supra* note 5, at A16 (“A top Democratic lawmaker suggested that earlier, stricter limits should have been placed on AIG. ‘Clearly there was a mistake at the beginning,’ said Rep. Barney Frank . . .”); *see also* Weisman et al., *supra* note 5, at A4 (suggesting that public outrage was related to the failure of Congress to specifically tax bonuses).

91. *See, e.g.*, Jake DeSantis, Op-Ed., *Dear A.I.G., I Quit!*, N.Y. TIMES, Mar. 25, 2009, at A29 (letter from an AIG Financial Products division executive who, while using strong rhetoric about the validity of contracts, is donating the approximately \$750,000 bonus he received to charity and quitting his job); *see also* Brady Dennis, *Challenges Remain for AIG, Employees*, WASH. POST, Apr. 14, 2009, at A11 (noting that employees at AIG’s Financial Products division have agreed to return more than \$50 million in bonus payments).

92. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No.

cy implications, the changed and unusual circumstances of an infusion of government money, the law of fraudulent conveyance, and the Attorney General of Connecticut's statements that there was never a potential liability issue, there could be a freeze on these executives' assets until the Secretary of the Treasury (or the new Special Master/Compensation Czar designee) has an opportunity to review the bonuses for fairness. State law might provide shareholders some redress in the form of an action for recovery under the corporate waste doctrine.<sup>93</sup> Although typically an exacting legal standard, the magnitude of the losses and these lavish rewards might actually provide an important test case for resurrecting the waste doctrine.<sup>94</sup> Finally, other agency or employment law principles, such as the faithless servant doctrine, might provide some redress for aggrieved shareholders.<sup>95</sup>

While there are possibilities for recovery, retroactive legislative responses or administrative rulemaking are difficult to fit within existing legal frameworks. Subsequent bills targeting bonuses distributed by TARP recipients have been introduced, but have also languished in Congress.<sup>96</sup> The Obama Administration and the Treasury Department, under pressure to take action, have cobbled together a multi-pronged approach in the months following the public outcry over executive bonuses. First, Kenneth Feinberg was named as a Special Master (termed in the media the "Compensation Czar") with oversight

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111-5, div. B, tit. VII, § 7001, 123 Stat. 115, 516-20 (amending the Emergency Economic Stabilization Act of 2008 § 111(b)(3)(D)(iii), 12 U.S.C.A. § 5221 (West Supp. 2009)).

93. See, e.g., *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 73-75 (Del. 2006) (discussing the corporate waste doctrine).

94. *Id.* at 74 ("A claim of waste will arise only in the rare, 'unconscionable case where directors irrationally squander or give away corporate assets.'") (citation omitted).

95. See RESTATEMENT (SECOND) OF AGENCY § 469 (1958) (stating that an agent who is disobedient or who breaches his duty of loyalty is not entitled to compensation); see also *Phansalkar v. Andersen Weinroth & Co.*, 344 F.3d 184, 200 (2d Cir. 2003) (stating that under New York law, "[o]ne who owes a duty of fidelity to a principal and who is faithless in the performance of his services is generally disentitled to recover his compensation, whether commissions or salary") (citation omitted). Although perhaps not as apt in the AIG situation, the faithless servant doctrine might have some application to Merrill Lynch—if allegations that the dates and timing of particular bonuses are accurate, that could implicate conflict of interest and duty of loyalty issues.

96. See *To Amend the Executive Compensation Provisions of the Emergency Economic Stabilization Act of 2008 to Prohibit Unreasonable and Excessive Compensation and Compensation Not Based on Performance Standards*, H.R. 1664, 111th Cong. (2009) (awaiting Senate approval).

responsibility for pay practices at the seven companies receiving the largest amounts of government assistance.<sup>97</sup> Second, the Treasury Department is now pressing for legislation and SEC rulemaking that would require a non-binding “Say on Pay” vote by shareholders at all publicly traded companies.<sup>98</sup>

Perhaps these recent efforts will finally bring the problem of excessive executive compensation to a larger national audience that is empowered to seek change. Nonetheless, the pending bonus tax highlights the problem of attempting a “retroactive clawback” through the avenue of legislation. The question posed then is what, going forward, can we do to fix the problems identified in a constructive and prospective fashion?

### C. REVERSE ALCHEMY: TURNING GOLD INTO LEAD

The credit crisis and subsequent bailouts have cast a long shadow of uncertainty over many aspects of investment banking, insurance, mortgage, and other industries. However, in addition to ensuring that credit continues to be available, the bailouts might well provide an opportunity for meaningful reform of executive compensation.<sup>99</sup> One way that this might be accomplished would be to write clawback provisions into executive compensation contracts prospectively. The change would result in the routine and widespread use of clawback provisions in executive compensation contracts, and could (at some point) result in a SEC mandate for such provisions.

#### 1. Prospective Voluntary Clawback Provisions

There are some indications that prospective voluntary clawback provisions might be becoming more commonplace. Over a year before the first bailout, computer giant Intel was already voluntarily implementing clawback provisions in the

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97. See Stephen Labaton, *Treasury to Set Executives' Pay at 7 Ailing Firms*, N.Y. TIMES, June 11, 2009, at A1 (discussing Feinberg's “broad discretion” to set salaries and bonuses at the seven companies).

98. See *supra* note 57 and accompanying text.

99. With a backward-looking glance, some of the federal programs that helped end the Depression are instructive. Stabilizing the economy is an important goal, but the New Deal is still better known for its social and regulatory programs than for its Keynesian deficit spending to stimulate economic recovery. Cf. William G. Ross, *When Did the “Switch in Time” Actually Occur?: Re-Discovering the Supreme Court's “Forgotten” Decisions of 1936–1937*, 37 ARIZ. ST. L.J. 1153, 1155–58, 1165–70 (2005) (describing the evolution of Supreme Court jurisprudence with respect to social and regulatory legislation during the New Deal era).

event that bonuses were paid out in error, on the basis of accounting results that had to be restated.<sup>100</sup> A recent study by a compensation-tracking firm, Equilar, noted that clawback provisions in executive contracts have started to gain more acceptance in the past two years.<sup>101</sup> The study examined the SEC disclosures of the ninety-five companies within the Fortune 100 that are publicly traded.<sup>102</sup> The study, however, defines “clawback provision” broadly, thus sweeping a large number of contracts, provisions, and policies under this umbrella term, even if they might not be particularly effective.<sup>103</sup> The effectiveness of any contractual remedy, as discussed in the Appendix, will depend on the language that the contract uses and how the clause is structured.

The investment firm Morgan Stanley, which received billions in the bailout, is one firm that has instituted a voluntary clawback clause.<sup>104</sup> As an internal memorandum from Morgan Stanley’s CEO John J. Mack disclosed at the end of 2008, their analysis of year-end bonuses also attempted “to tie compensation more closely to multi-year performance and each employee’s contribution to the Firm’s sustainable profitability.”<sup>105</sup> The memorandum goes on to state that the compensation packages will “include a new clawback provision which [Morgan Stanley] will implement as a permanent part of our compensation policy:”

In 2008 and beyond, for all bonus-eligible employees, we are making part of the year-end bonus deferral a cash award subject to a clawback provision that could be triggered if the individual engages in conduct detrimental to the Firm. The clawback could be triggered if an individual, for example, caused the need for a restatement of results, a significant financial loss or other reputational harm to the Firm or one of its businesses. . . . Starting in 2009, we expect to institute a multi-year performance plan for senior executives, including the CEO, that will tie a portion of their compensation directly to the Firm’s performance over a three-year period—with one third of this

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100. See Gretchen Morgenson, *Intel Can Recover Bonuses It Shouldn’t Have Paid*, N.Y. TIMES, Mar. 31, 2007, <http://www.nytimes.com/2007/03/31/business/31chip.pay.html?ref=businessspecial>.

101. See *Executive Compensation Trends*, EQUILAR, Nov. 2008, at 6–11 (noting that the prevalence of Fortune 100 companies with disclosed clawback policies increased from 17.6% to 64.2% between 2006 and 2008).

102. *Id.*

103. *Id.*

104. See *Morgan Stanley Executives Forgo Bonuses, as Program Is Changed*, <http://dealbook.blogs.nytimes.com/2008/12/08/morgan-stanley-executives-forego-bonuses-as-program-is-changed/> (Dec. 8, 2008, 15:31 EST).

105. *Id.*

compensation tied to the Firm's return on equity (ROE), a second third tied to Morgan Stanley's relative ROE versus our peers, and the final third tied to total shareholder return on a relative basis.<sup>106</sup>

According to a *New York Times* story, while Morgan Stanley's clawback is broader, it was actually modeled after an earlier November announcement by UBS.<sup>107</sup>

In voluntarily adopting and implementing clawback provisions, many companies are attempting to fix the compensation disconnect.<sup>108</sup> The amount of actual reform, of course, will depend on the specifics of the clawback provision itself.<sup>109</sup> Because these contracts are individually negotiated, there is room for variation.<sup>110</sup> Some clawback provisions require that an employee be actually involved in a fraud in order to trigger the repayment requirement.<sup>111</sup> Others merely require the amounts to have been paid in error based on incorrect accounting results.<sup>112</sup>

## 2. The Silver Lining of Prospective Reform

One of the questions that would naturally arise is why corporations would voluntarily choose to institute clawback provisions, or perhaps, the more insightful question is why any leading executives would agree to them?<sup>113</sup> If Bebchuk and Fried are correct in describing their managerial power thesis, and if previous efforts to constrain executive pay have been unsuccessful, why would clawback provisions be any different? After all, executive compensation has either stayed at the same le-

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106. *Id.*

107. See Story, *supra* note 83.

108. See *infra* Appendix (referencing clawback provisions, culled from SEC disclosures, in various corporate compensation policies).

109. See *infra* Appendix (categorizing clawback provisions according to those triggered by bad faith, fraud or misconduct, and restatement of financial results).

110. See *infra* Appendix.

111. See *infra* Appendix, Part B.2 (citing the American Express clawback policy, which triggers only upon the board's finding that an employee's fraud or misconduct has caused (or partially caused) a restatement of financial results).

112. See, e.g., Morgenson, *supra* note 100 (describing the Intel clawback provision, which allows recovery of any bonuses "generated by an error or a misstatement that affected the company's results").

113. Cf. Joann S. Lublin, *More Directors Are Cutting Their Own Pay*, WALL ST. J., Mar. 16, 2009, at B1 (describing how directors at several companies, including General Motors, Ford, Eddie Bauer, and Herman Miller are reducing their own pay in an effort to show leadership and improve company performance).



vels or increased, even in the face of tax regulations,<sup>114</sup> mandated disclosure,<sup>115</sup> and shareholder lawsuits.<sup>116</sup>

There is reason to think, however, that clawback provisions might prove more durable and effective than past efforts. Politically, this is an excellent time for reform. Currently there is a high level of public outrage—created in large part by the economic crisis—at executive pay, the bonuses, the large risks taken, and the liabilities created for the government.<sup>117</sup> Companies therefore have the incentive, for public relations purposes if nothing else, to include contractual clawbacks in their employment contracts.

Additionally, the political impetus may yet result in government regulation mandating such clawbacks. At the moment, these contractual clawbacks are voluntary provisions and constitute “best practices.”<sup>118</sup> However, some language from the Treasury Department in a recent press release raises the possibility that what we might now consider the early emergence of a “best practice” may become a part of future federal regulation.<sup>119</sup> In a recent release, the Department of the Treasury stated:

The Secretary of the Treasury and the Chairman of the Securities and Exchange Commission should work together to require compensation committees of all public financial institutions—*not just those receiving government assistance*—to review and disclose executive and certain employee compensation arrangements and explain how these compensation arrangements are consistent with promoting sound risk management and long-term value creation for their companies and their shareholders. . . . Over the last decade there has been an emerging consensus that top executives should receive compensation that encourages more of a long-term perspective on creating economic value for their shareholders and the economy at large. One idea worthy of serious consideration is requiring top executives at financial institutions to hold stock for several years after it is awarded before it can

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114. See *supra* Parts I.A, I.B.1–2.

115. See *supra* Part I.A.2.

116. Cf. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 74 (Del. 2006) (“[T]he onerous standard for [corporate] waste is a corollary of the proposition that where business judgment presumptions are applicable, the board’s decision will be upheld unless it cannot be attributed to any rational business purpose”).

117. See, e.g., Phillips, *supra* note 5.

118. Cf. David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294, 307–08 (2006) (describing “best practices” in both administrative agencies and business management as a “curiosity,” since the term is oft-used but ill-defined).

119. Press Release, U.S. Dep’t of the Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), <http://www.ustreas.gov/press/releases/tg15.htm>.

be cashed-out as this would encourage a more long-term focus on the economic interests of the firm.<sup>120</sup>

Similar intimations were made in a recent speech by an SEC official, who suggested that companies not involved in the bailout might nonetheless wish to follow these limitations for guidance on best practices.<sup>121</sup> While currently voluntary, these provisions could be mandated in the future.<sup>122</sup>

We believe that the demands for change engendered by the financial crisis can provide a “silver lining”—a genuine opportunity for meaningful change in the executive compensation arena. One of the major problems with executive compensation has been a focus only upon short-term performance. Such short-term thinking often leads to opportunistic behavior, at the expense of the long-term health of the company. By in a sense operating as a “lead parachute,” prospective clawback provisions begin to align incentives over a longer time frame.

## II. CLAWBACKS IN PONZI SCHEMES

The Madoff hedge fund fraud has grabbed headlines the world over, and with good reason. Apart from its soap opera-like aspects,<sup>123</sup> both the sheer scope of the fraud and the fact that ostensibly sophisticated investors across the globe from

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120. *Id.* (emphasis added).

121. See JOHN W. WHITE, DIRECTOR, DIV. OF CORP. FIN., SEC. AND EXCH. COMM'N., EXECUTIVE COMPENSATION DISCLOSURE: OBSERVATIONS ON YEAR TWO AND A LOOK FORWARD TO THE CHANGING LANDSCAPE FOR 2009 (2008), <http://www.sec.gov/news/speech/2008/spch102108jww.htm> (urging nonparticipating institutions to “carefully” consider integrating risk-reducing TARP regulations into company compensation policies).

122. See Richard R. Floersch, *The Right Way to Determine Executive Pay*, WALL ST. J., Mar. 5, 2009, at A15 (“In this climate, those responsible for setting the parameters in the private sector need to start asking the right questions and taking actions, even if the results aren’t popular among executives. If they don’t, Congress will likely seek to change the way compensation is provided.”).

123. Bernard Madoff confessed the fraud to his two sons, telling them he believed that the losses from the fraud exceeded \$50 billion and that he would turn himself in, but not before distributing some \$200 to \$300 million in the fund’s accounts to certain employees. In response, the two sons turned Madoff in to the authorities. See Amir Efrati et al., *Top Broker Accused of \$50 Billion Fraud*, WALL ST. J., Dec. 12, 2008, at A1. Rene-Thierry Magon de la Villehuchet, a prominent investor who traced his lineage to French aristocracy and had more than \$1 billion of his clients’ money entrusted with Madoff, committed suicide when the extent of the loss came to light. See Associated Press, *Suicide Madoff Investor Was ‘Honorable Man,’* Dec. 24, 2008, <http://www.msnbc.msn.com/id/28368421/>.

Abu Dhabi to Zurich were duped by a sprawling Ponzi scheme have gained the story a widespread and deserved notoriety.<sup>124</sup>

Bernard L. Madoff, a former chairman of the NASDAQ Stock Market and a well-respected figure on Wall Street before his dramatic arrest in 2008,<sup>125</sup> first began to lure investors into his scheme in the early 1990s.<sup>126</sup> He attracted not only institutional clients like hedge funds, pension funds, and charitable organizations,<sup>127</sup> but also prominent wealthy individuals such as Steven Spielberg, billionaire art collector Norman Braman, New York Mets owner Fred Wilpon, and actor Kevin Bacon.<sup>128</sup> While his clients were told their investments were turning handsome profits in a hedge fund, Madoff had not been purchasing any securities in the decade leading to his arrest, never mind creating a hedge fund.<sup>129</sup>

In order to keep up appearances, Madoff claimed to have employed a “split-strike conversion strategy, investing in a basket of stocks that would closely mimic the price movements of the Standard & Poor’s 100 Index, rotating out of the market into government-issued securities like treasury bills and hedging the investments by buying and selling option contracts related to those stocks.”<sup>130</sup> Madoff would further provide clients with false trading confirmations and account statements reflecting bogus transactions in support of “this mythical ‘split-strike conversion strategy.’”<sup>131</sup> All the while, Madoff was simply paying off the early investors with funds generated from later investors.

Although there were skeptics who have insisted for years that Madoff could not have been investing his money legitimately, most accepted and believed that Madoff was a skilled investor with a proprietary investing platform that virtually

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124. See Diana Henriques, *Vast Wall Street Fraud Knew No Boundaries*, INT’L HERALD TRIB., Dec. 22, 2008, at 12.

125. See Efrati et al., *supra* note 123.

126. See Mark Hamblett, *Madoff Pleads and Is Led Off to Jail*, N.Y. L.J., Mar. 13, 2009, at 1, 7 (summarizing Madoff’s guilty plea).

127. See *id.* at 7.

128. See Keren Blankfeld Schultz & Duncan Greenberg, *Bernie Madoff’s Billionaire Victims*, FORBES, Mar. 12, 2009, <http://www.forbes.com/2009/03/12/madoff-guilty-plea-business-wall-street-celebrity-victims.html>. No doubt Kevin Bacon wishes there were more than six degrees of separation between him and Madoff.

129. See Hamblett, *supra* note 126, at 7.

130. *Id.*

131. *Id.*

could not lose.<sup>132</sup> Indeed, when Madoff was reported to the SEC, the agency failed to conduct a thorough investigation in part because of his sterling reputation on Wall Street.<sup>133</sup> In retrospect, with more complete information on Madoff's investments, the alleged returns now appear to be virtually—and in some cases, truly—impossible to achieve. Madoff informed investors that he returned an average of 15.7% per year since January 1996.<sup>134</sup> Between January 1996 and December 2004, a loss was reported only for three months, and most months reflected between 1% and 1.5% returns.<sup>135</sup> Moreover, Madoff claimed to be executing more option trades than the entire market had on many days.<sup>136</sup>

Unwieldy as it was, the “hedge fund” kept growing until 2008. At that point, presumably because of the downturn in the economy, it became impossible for Madoff to recruit enough new money to keep it afloat.<sup>137</sup> While Madoff allegedly confessed to running a \$50 billion scheme, investigators are still uncertain about how much money was actually lost.<sup>138</sup> Notwithstanding, the shortfall is staggering given that authorities have located only about \$830 million in assets belonging to Madoff, including such eclectic items as a \$39,000 piano and a \$320,000 boat tragically named “Sitting Bull.”<sup>139</sup> Madoff has since pleaded guilty in federal court to eleven felony counts, including securities fraud, wire fraud, mail fraud, money laundering, perjury, and false filings with the SEC.<sup>140</sup> On June 29,

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132. See Gregory Zuckerman & Kara Scannell, *Madoff Misled SEC in '06, Got Off*, WALL ST. J., Dec. 18, 2008, at A1.

133. See *id.*

134. See Amir Efrati et al., *Top Wall Street Broker Accused of Fraud*, WALL ST. J., Dec. 12, 2008, <http://www.wealth-bulletin.com/people/content/3352771135/>.

135. See *id.*

136. See Tom Lauricella et al., *Madoff Ran Vast Options Game*, WALL ST. J., Dec. 16, 2008, at A19.

137. See *id.* (explaining that with the ten percent loss in the stock market in November 2008, Madoff could no longer attract investors).

138. See Efrati & Frank, *supra* note 12 (reporting that after admitting to an initial fifty billion dollars in losses, Madoff subsequently issued statements indicating he had lost almost sixty-five billion in investments).

139. See Zachery Krouwe, *Madoffs Worth \$823 Million, a Filing Says*, N.Y. TIMES, Mar. 14, 2009, at B8.

140. See Press Release, United States Attorney S. Dist. of N.Y., Bernard L. Madoff Pleads Guilty to Eleven-Count Criminal Information and Is Remanded into Custody (Mar. 12, 2009), <http://www.usdoj.gov/usao/nys/pressreleases/March09/madoffbernardpleapr.pdf>.

2009, he was sentenced to 150 years in prison.<sup>141</sup>

Quite apart from its more sensational aspects, however, the fraud raises a series of complex and intriguing remedial questions: What remedies, if any, are available to investors who have lost some or all of their investment (“losing investors”) as against those investors who have profited from the scheme (“winning investors”)?<sup>142</sup> Do these remedies sufficiently protect such later investors and do or should they have the effect of deterring the fraud in the first place? If not, should we look to private ordering to solve this problem before turning to regulation?

These remedial questions arise because although the losing investors can turn to the courts to hold the operator of the fraud accountable, they are often forced to look elsewhere because the scheme and the operator are insolvent.<sup>143</sup> The Madoff fraud serves as a prime example: while the investors will already be in line with other creditors in the Madoff bankruptcy proceedings, the value of his assets is substantially less than the loss incurred by the investors.<sup>144</sup>

In a Ponzi scheme, losing investors would therefore look, naturally enough, to other solvent investors who have profited from the scheme, whether witting or not.<sup>145</sup> If the winning investor was aware of the fraud, that investor could be required to disgorge all payments received, which are avoidable as fraudulent transfers.<sup>146</sup> Because many, if not most of the investors,

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141. See Robert Frank & Amir Efrati, *‘Evil’ Madoff Gets 150 Years in Epic Fraud*, WALL ST. J., June 30, 2009, at A1.

142. Although in many Ponzi schemes, those who profit are early investors, and those who lose are investors who enter the fray later, this is not necessarily the case. Whether an investor ends up losing or winning depends on the structure of the particular scheme and the choices made by the particular investor.

143. See Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 159–81 (1998) (stating that the estates of Ponzi schemes are generally nonliquid and that the greatest assets of such estates are claims against winning investors).

144. See Associated Press, *supra* note 138 (noting that while investors may have lost up to \$17 billion, Madoff’s assets are estimated at less than \$1 billion).

145. For example, as of May 15, 2009, the trustee had “already sued to recover \$10.1 billion from six investors who withdrew substantial amounts from their Madoff accounts in the final years of the Ponzi scheme.” Diana B. Henriques, *Trustee Sends \$30 Million to Victims of Madoff Fraud*, N.Y. TIMES, May 15, 2009, at B3.

146. See *Wyle v. Rider (In re United Energy Corp.)*, 944 F.2d 589, 596 n.7 (9th Cir. 1991) (“[W]e assume that the investors had no knowledge of the fraud

are innocent of the fraud,<sup>147</sup> the more useful but difficult question—and therefore the subject of this Part of the Article—is whether any remedies lie as against innocent winning investors.

A short introduction to Ponzi schemes in general is in order. Named after Charles Ponzi, the operator of the fraudulent scheme in *Cunningham v. Brown*,<sup>148</sup> a Ponzi scheme is an enterprise that “makes payments to investors with monies received from newly attracted investors, rather than from profits of a legitimate business venture. Generally, investors are promised large returns on their investments, and initial investors are paid sizeable returns.”<sup>149</sup> The money from later investors is then used to repay the earlier investors in order to keep the scheme afloat.<sup>150</sup> Throughout this exercise, the promoter or Ponzi scheme operator draws off money from the enterprise, creating a loss. Ultimately, as the enterprise gets further and further into debt, the scheme collapses, leaving many but not all investors without their principal investments or the promised profits.<sup>151</sup> This phenomenon, as described above, is precisely what happened in the Madoff fraud.<sup>152</sup> The question that presents itself is whether the losing investors may proceed against the winning investors in the course of the bankruptcy proceedings that often follow.<sup>153</sup>

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the debtors were perpetrating. If investments were made with culpable knowledge, all subsequent payments made to such investors within one year of the debtors' bankruptcy would be avoidable [as fraudulent transfers], regardless of the amount invested . . .”).

147. See, e.g., Eduardo J. Glas, *Redemption Payments Salvaged Prior to the Collapse of Ponzi Schemes*, BANKR. STRATEGIST, July 2007, at 3 (noting that Madoff's hedge fund “turned out to be a massive Ponzi scheme that snared a large number of innocent investors”).

148. *Cunningham v. Brown*, 265 U.S. 1, 7–9 (1924).

149. *Collins v. Fisher (In re Lake States Commodities, Inc.)*, 253 B.R. 866, 869 n.2 (Bankr. N.D. Ill. 2000).

150. See *Cunningham*, 265 U.S. at 8 (explaining that the operator was able to make payments to previous investors solely by obtaining new loans).

151. See *id.* at 10–11 (outlining the consequences of a collapsing Ponzi scheme).

152. See *supra* notes 129–38 and accompanying text.

153. See Nancy C. Dreher, *Ninth Circuit Holds that the UFTA Covers an Action to Recover the Profit Made by Innocent Investors in a Ponzi Scheme*, 9 BANKR. SERV. CURRENT AWARENESS ALERT No. 7 (2008) (“A common epilogue to a collapsed Ponzi scheme is a bankruptcy proceeding, and federal bankruptcy law expressly permits actions under the UFTA.”). The investor may additionally turn to the congressionally created Securities Investor Protection Corporation (SIPC), an institution that insures investor accounts in the event a brokerage firm fails. See Securities Investor Protection Corporation, Our 38-

As the discussion below will show, to the extent fraudulent transfer laws apply, any payments made to an innocent winning investor that is in excess—and only in excess—of the amounts of principal that she originally invested may be recoverable as fraudulent transfers. While this doctrine provides some protection for the losing investor, it is a less-than-optimal solution as this will still leave the winning investors in a better position vis-à-vis the losing investors, even though both groups may be equally innocent and pure circumstance alone determines which group any investor falls into. Further, such disparate outcomes may provide a disincentive to an investor to disclose any post-investment discovery of such fraud at least until that investor's principal is recouped.<sup>154</sup> The introduction of clawback provisions in such investment contracts will not only potentially allocate the loss and therefore risk more evenly, it will also counter the disincentive to disclose. Significantly, because investors cannot generally determine beforehand whether they will be winning or losing investors, investors as a group will have the incentive to rely on and thus include clawback provisions in their investment contracts.

#### A. RECOVERY UNDER FRAUDULENT TRANSFER LAWS

To recover fraudulent transfers made by a debtor, a trustee may bring a claim under either § 548 or § 544(b) of the Bankruptcy Code, which incorporates state fraudulent transfer laws.<sup>155</sup> In most states, such laws are derived from either the

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Year Track Record for Investors, <http://www.sipc.org/who/sipctrackrecord.cfm> (last visited Nov. 8, 2009). Unfortunately, the SIPC only insures up to \$500,000 per account and the scale of the Madoff fraud coming after the failure of Lehman has led the CEO of SIPC to question whether "SIPC's resources will be adequate" to cover current losses. See Posting of Mary Pilon to The Wallet, Wall Street Journal Blog, Is the SIPC Sick? <http://blogs.wsj.com/wallet/2009/01/30/is-the-sipc-sick/> (Jan. 30, 2009, 11:01 EST). As of May 15, 2009, 125 claims have been approved for payment of losses adding up to \$368 million. See Henriques, *supra* note 145. Almost all of the checks that have been mailed were for \$500,000. See *id.*

154. See *infra* notes 204–04 and accompanying text.

155. 11 U.S.C. §§ 544(b), 548 (2006). See generally McDermott, *supra* note 143, at 159–81. Additionally, the trustee may be able to recover certain payments to the investors as a preference. See *id.* at 188. However, because preferential transfer law under the Bankruptcy Code applies only to transfers made within the ninety-day period prior to the filing of the debtor's bankruptcy case, see 11 U.S.C. § 547(b) (2006), its reach will generally be more limited than that of fraudulent transfer laws. See 11 U.S.C. § 548 (2006) (allowing the trustee to reach back two years in certain circumstances); cf. McDermott, *supra*, at 181 (noting the potential advantage of a preference action in allowing the trustee

Uniform Fraudulent Transfer Act (UFTA) or the older Uniform Fraudulent Conveyance Act (UFCA).<sup>156</sup> “[T]here are but a few substantive distinctions between the two uniform statutes, or between the two statutes and [section] 548 of the Bankruptcy Code.”<sup>157</sup> One major distinction among the provisions is the applicable reachback period: While § 548 of the Bankruptcy Code allows avoidance of only those transfers made within two years of the petition date,<sup>158</sup> the reachback time period for fraudulent transfer claims under most state laws (which are based on either the UFTA or UFCA) is four years.<sup>159</sup> In general, however, “the basic principles governing fraudulent transfer actions are the same, regardless of the statutory basis used.”<sup>160</sup>

As a typical example, the UFTA provides in relevant part that:

(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or

(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

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to recover the return of an investor's principal, even though the investor made the investment in good faith).

156. See David F. Kurzawa II, Note, *When Fair Consideration Is Not Fair*, 11 CORNELL J.L. & PUB. POL'Y 461, 464–65 (2002).

157. See McDermott, *supra* note 143, at 159–60.

158. See 11 U.S.C. § 548(a)(1).

159. See Lisa A. Dunskey, *In re Bayou Group, LLC: The “Hotel California” Effect in Bankruptcies of Fraudulent Hedge Funds*, FUTURES & DERIVATIVES L. REP., Feb. 2008, at 15 (noting that although it varies by state, the reachback period for fraudulent transfer claims is typically four years, and further distinguishing the reachback period from the statute of limitations governed by § 546(a) of the Bankruptcy Code); see also David R. Weinstein & Gil Hoppenstand, *Reachbacks, Statutes of Limitation and Deadlines: Demystifying the Avoiding Powers*, 26 AM. BANKR. INST. J. 63, 65 n.12 (2007) (“The pertinent provisions of the UFTA, usually § 9 [which describes a period of four years], are most often the source of the ‘look back’ period . . .”).

160. *Daly v. Deptula (In re Carrozzella & Richardson)*, 286 B.R. 480, 483 n.3 (D. Conn. 2002); see also *Rieser v. Hayslip (In re Canyon Sys. Corp.)*, 343 B.R. 615, 634 n.15 (Bankr. S.D. Ohio 2006) (“The fraudulent transfer provisions of the Code and the UFTA are substantially similar.”) (citation omitted); *Pajaro Dunes Rental Agency, Inc. v. Spitters (In re Pajaro Dunes Rental Agency, Inc.)*, 174 B.R. 557, 572 (Bankr. N.D. Cal. 1994) (noting that case law regarding bankruptcy proceedings may be cross-referenced even if it discusses an alternative statutory basis).



(i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.<sup>161</sup>

Courts have applied fraudulent conveyance laws to allow receivers or trustees in bankruptcy to recover money from winning investors in a Ponzi scheme.<sup>162</sup> Specifically, there are two theories of recovery that a trustee may rely upon under the fraudulent conveyance laws in these circumstances: actual fraud and constructive fraud.<sup>163</sup> However, under either theory, a trustee's recovery as against the innocent winning investor will generally be limited to recovering the profits earned by the winning investor, and will not extend to any amount representing a return of the investor's principal.<sup>164</sup>

In recovering under either theory, the trustee must prove that the debtor (i.e., Ponzi scheme operator) had "an interest" in the property transferred.<sup>165</sup> There is no dispute in many fraudulent transfer actions arising in the context of bankruptcies involving Ponzi schemes that funds received involve property in which the debtor has an interest.<sup>166</sup> To the extent that proposition has been disputed, courts have generally rejected such challenges, and have held that debtors under these circumstances have an interest in funds transferred to the investors.<sup>167</sup>

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161. UNIF. FRAUDULENT TRANSFER ACT § 4(a), 7A U.L.A. pt.II, at 58 (2006).

162. See, e.g., *Scholes v. Lehmann*, 56 F.3d 750, 757–58 (7th Cir. 1995) (requiring a profiting investor to return the amount of the profits to a receiver); *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Group)*, 916 F.2d 528, 540–41 (9th Cir. 1990).

163. See McDermott, *supra* note 143, at 159–60.

164. See *id.* (noting that recovery is limited to profits unless the profiting investor had knowledge of the fraud).

165. 11 U.S.C. §§ 544(b)(1), 548(a)(1) (2006); see also McDermott, *supra* note 143, at 160.

166. See McDermott, *supra* note 143, at 161 (explaining that in many cases the property in dispute was either property belonging to the debtor, or property in which he had an interest).

167. See, e.g., *Merrill v. Abbott (In re Indep. Clearing House)*, 77 B.R. 843, 854 (C.D. Utah 1987) ("[W]hen a debtor obtains money by fraud and mingles it with other money so as to preclude any tracing and when the defrauded party . . . accepts benefits under his contract with the debtor, the money is 'property' of the debtor within the meaning of §§ 547 and 548 of the Code."); *Rieser v. Hayslip (In re Canyon Sys. Corp.)*, 343 B.R. 615, 635 (Bankr. S.D. Ohio 2006) ("Payments made to investors in a Ponzi scheme constitute 'transfers' within the meaning of both § 101(54) of the Code and § 1336.01(L) of the Ohio UFTA.

To recover under the actual fraud theory, the trustee must further prove that the debtor made transfers to the winning investor "with actual intent to hinder, delay, or defraud" the losing investors,<sup>168</sup> a burden readily met under these circumstances given that courts have held that "the mere existence of a Ponzi scheme is sufficient to establish [such] actual intent."<sup>169</sup> Although proving actual fraud would ordinarily allow the trustee to recover all transfers made to a winning investor, including amounts which could be considered return of principal, there is a good faith defense that permits an innocent winning investor to retain funds up to the amount of the principal.<sup>170</sup>

To recover under the constructive fraud theory, the trustee must additionally show that the transfer was made: (1) with the debtor receiving "less than a reasonably equivalent value in exchange for such transfer;" and (2) under circumstances involving one of three insufficient funds situations (including the situation where the debtor was insolvent at the time of transfer) or else to an insider under an employment contract and outside the ordinary course of business.<sup>171</sup>

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Further, a Ponzi scheme operator possesses a property interest in the transferred funds.") (citations omitted); *Floyd v. Dunson* (*In re Ramirez Rodriguez*), 209 B.R. 424, 432 (Bankr. S.D. Tex. 1997) ("Funds obtained from investors in a Ponzi scheme are property of debtor, and are thus susceptible to preferential and fraudulent disposition by debtor."); *Jobin v. Lalan* (*In re M & L Bus. Mach. Co.*), 160 B.R. 851, 857 (Bankr. D. Colo. 1993) (noting that because the investors gave their money voluntarily, the debtor had a legal right to possession) ("It is elemental property law that one of the 'interests in property' included in the total bundle of property rights is the right of possession. All that § 548 requires is the transfer of an 'interest' by the Debtor."). *Id.*

168. 11 U.S.C. § 548(a)(1)(A).

169. *Barclay v. Mackenzie* (*In re AFI Holding, Inc.*), 525 F.3d 700, 704 (9th Cir. 2008); cf. 5 COLLIER ON BANKRUPTCY ¶ 548.04[2][a] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2009) (noting that the plaintiff meets the requirement on demonstrating that the transferor "acted under circumstances that preclude any reasonable conclusion other than that the purpose of the transfer was fraudulent as to creditors").

170. According to § 548(c) of the Bankruptcy Code:

[A] transferee or obligee of . . . a [fraudulent] transfer or obligation that takes for value *and in good faith* has a lien on or may retain any interest transferred or may enforce any obligation incurred . . . to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. § 548(c) (emphasis added); see also *Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995) (allowing a winning investor to keep all repaid principal because he invested in good faith). See generally McDermott, *supra* note 143, at 175–81 (explaining the good faith defense in the context of actual fraud).

171. Section 548(a) of the Bankruptcy Code provides as follows:

(a)(1)The trustee may avoid any transfer (including any transfer to or

Courts in general hold that a debtor does not receive a reasonably equivalent value for any payments made to the winning investor that represent profits since such profits are regarded as having been gained through theft from losing investors.<sup>172</sup> Where the winning investor receives more than was invested, such “[p]ayments in excess of amounts invested are considered fictitious profits because they do not represent a return on legitimate investment activity.”<sup>173</sup> In contrast, courts generally hold that a debtor receives value for returning an investor’s principal investment.<sup>174</sup> The rationale here is that the investor has a claim for restitution against the debtor for the investor’s principal investment by virtue of the debtor’s fraud;<sup>175</sup> this claim constitutes a debt owed by the debtor to the investor.<sup>176</sup>

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for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily:

....  
 (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

11 U.S.C. § 548(a). See generally McDermott, *supra* note 143, at 164–73 (explaining the elements of constructive fraud in the context of Ponzi schemes).

172. See *Scholes*, 56 F.3d at 757 (requiring a winning investor to return the profits that constituted a theft from later investors); *Dreher*, *supra* note 153, § 7.

173. *Fisher v. Sellas (In re Lake States Commodities, Inc.)*, 253 B.R. 866, 872 (Bankr. N.D. Ill. 2000) (citations omitted).

174. See McDermott, *supra* note 143, at 165.

175. See, e.g., *Wyle v. Rider (In re United Energy Corp.)*, 944 F.2d 589, 595 (9th Cir. 1991) (noting that investors have a claim to restitution because they were “duped” into buying solar modules); *Rosenberg v. Collins*, 624 F.2d 659, 664 (5th Cir. 1980) (holding that the debtor owes a debt to the creditors).

176. The Bankruptcy Code defines a “claim” as:

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unma-

Additionally, proving the existence of one of the three insufficient funds situations is typically a straightforward matter for the trustee because courts have held that a debtor operating a Ponzi scheme is deemed insolvent from its inception as a matter of law.<sup>177</sup>

As a result, federal courts generally determine whether the investor is liable by applying the so-called netting rule.<sup>178</sup> Under this rule, amounts transferred by the Ponzi scheme perpetrator to the investor are netted against the initial amounts invested by that individual.<sup>179</sup> If the net is positive, the receiver has established liability, and the court then determines the actual amount of liability, which may or may not be equal to the net gain, depending on factors such as whether transfers were made within the relevant reachback period or whether the investor lacked good faith.<sup>180</sup> If the net is negative, the good faith (innocent) investor is not liable because as described above, payments received in amounts less than the principal investment are not avoidable under fraudulent transfer laws.<sup>181</sup>

Thus, the general rule regarding recovery as against innocent winning investors in Ponzi schemes is that only payments made to them in excess of the amounts of principal originally invested are avoidable as fraudulent transfers. The remaining assets in the scheme, as well as the fraudulent transfers recovered, are then ratably distributed among all of the creditors,

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tured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

11 U.S.C. § 101(5) (2006). Section 101(12) defines "debt" as a "liability on a claim." *Id.* § 101(12).

177. See, e.g., *Cunningham v. Brown*, 265 U.S. 1, 8 (1924) (explaining that a Ponzi scheme debtor was always insolvent and became more so each day the business continued); *Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir. 2006) (observing that a Ponzi scheme "is, as a matter of law, insolvent from its inception") (citation omitted); *Guy v. Abdulla*, 57 F.R.D. 14, 17 (N.D. Ohio 1972) (noting that it was possible to establish that a Ponzi scheme was insolvent from its very inception); *Cuthill v. Kime (In re Evergreen Sec., Ltd.)*, 319 B.R. 245, 253 (Bankr. M.D. Fla. 2003) ("Insolvency of the debtor as required by § 548(a)(1)(B) is established, when the Debtor is operating a Ponzi scheme.").

178. See McDermott, *supra* note 143, at 168–69; *id.* at 169 n.49 (referring to the rule as the "netting" rule).

179. See *id.* at 168–69.

180. See *id.* (pointing out that an investor may be liable for all repayments, including returned principal, if they lacked good faith).

181. See *supra* Part II.A.

both losing investors and other non-investor creditors of the estate.<sup>182</sup> Broadly speaking, the rationale for this approach is that “winners” in the Ponzi scheme, even if innocent of any fraud themselves, are not in an equitably stronger position vis-à-vis the losing investors, and should not be permitted to benefit at the expense of the losing investor. As one court framed the issue:

The money used for the [underlying investments] came from investors gulled by fraudulent representations. [The defendant] was one of those investors, and it may seem “only fair” that he should be entitled to the profits on trades made with his money. That would be true as between him and [the Ponzi scheme operator]. It is not true as between him and either the creditors of or the other investors in the corporations. He should not be permitted to benefit from a fraud at their expense merely because he was not himself to blame for the fraud. All he is being asked to do is to return the net profits of his investment—the difference between what he put in at the beginning and what he had at the end.<sup>183</sup>

This observation would, technically, hold true for the Madoff fraud as well. To the extent the investors in the Madoff fraud are equally blameless, courts could hold that the investor who pulls out early to cash in on the profit is on par, equitably speaking, with the investor who leaves funds in and therefore loses his investment, and treat the former’s profits as fraudulent transfers.

#### B. THE RESULTING INEQUITY BETWEEN WINNING AND LOSING INVESTORS

The remedies currently provided under the law are less than satisfactory since it will be a matter of chance whether a particular innocent investor is a winning or a losing investor. In other words, even though both the winning and the losing investor are equally blameless, the latter will suffer the greater loss in relative terms quite simply because that investor was “not so lucky.”<sup>184</sup> As noted above, it is precisely this unfairness that justifies the treatment of any payments made to the winning investors representing profit that is avoidable as fraudu-

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182. See McDermott, *supra* note 143, at 158 (“[T]he bankruptcy trustee must collect whatever assets are available in order to pay both the investors who lost money and any other creditors of the estate.”).

183. Scholes v. Lehmann, 56 F.3d 750, 757–58 (7th Cir. 1995).

184. Wyle v. Rider (*In re United Energy Corp.*), 944 F.2d 589, 596 (9th Cir. 1991).

lent transfers and requires their disgorgement for the benefit of the losing investors.<sup>185</sup>

While ameliorating the situation to some degree, fraudulent conveyance laws are highly unlikely to bring both sets of investors to parity.<sup>186</sup> This disparity is further compounded by the fact that while payments of fictitious profit are potentially avoidable as fraudulent conveyances, the relevant reachback period may further restrict the payments the Ponzi scheme investor is required to repay. Only transfers made within the reachback period are avoidable.<sup>187</sup> In the case of an extensive fraud like that perpetuated by Madoff, the Ponzi scheme can extend over a decade. Those initial and innocent winning investors who withdrew their money, say, ten years ago, would effectively be removed from the equation.

For these reasons, “courts have long held that it is more equitable to attempt to distribute all recoverable assets among the defrauded investors who did not recover their initial investments rather than to allow the losses to rest where they fell.”<sup>188</sup> Indeed, because the typical losing investor nonetheless remains at an unfair disadvantage,<sup>189</sup> courts have sought to rectify the balance in other ways.

For example, courts have begun to adopt a narrower reading of the good faith defense so as to potentially reach all payments received by an investor from the scheme, and not just the amounts representing the fictitious profits. In *In re Bayou Group, LLC*, a recent case involving another massive hedge fund fraud, the Ponzi scheme persisted for years as a result of management’s falsification of its financial disclosures and frau-

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185. See *supra* notes 182–82 and accompanying text.

186. See, e.g., *Donell v. Kowell*, 533 F.3d 762, 776 (9th Cir. 2008) (“According to the Receiver, in this case approximately 6,000 investors participated in the . . . Ponzi scheme, but only about 800 received back more than their initial investment. It is likely that many of the other 5,200 losing investors will see only a portion of their initial investment returned.”); cf. *id.* (“[A]ssets recovered after a collapsed Ponzi scheme typically are insufficient to satisfy claims by losing investors” (citing McDermott, *supra* note 143, at 158–59)).

187. See *Warfield v. Alaniz*, 453 F. Supp. 2d 1118, 1130–31 (D. Ariz. 2006) (holding that a court-appointed receiver could not base his claims under Arizona’s UFTA on fraudulent transfers that took place outside of the relevant time period), *aff’d* 569 F.3d 1015 (9th Cir. 2009); *Neilson v. Union Bank of Cal.*, 290 F. Supp. 2d 1101, 1145–46 (C.D. Cal. 2003) (explaining that a claim of intentional fraudulent transfer under California’s UFTA is extinguished if it is not made within the statutory period); see also *supra* notes 165–66 and accompanying text.

188. *Donell*, 533 F.3d at 776.

189. See *supra* notes 178–80 and accompanying text.

dule nt misrepresentation of its investment performances.<sup>190</sup> This was facilitated in part by management's termination of its independent auditor and the creation of a fictitious accounting firm to pose as the independent auditor.<sup>191</sup> The court ruled that under the actual fraud recovery theory,<sup>192</sup> winning investors would have to hand back their principal as well as their profits, even though they were not responsible for the fraud, if there was evidence that they redeemed their investments after there was a "red flag" that "put[] the investor on notice of some potential infirmity in the investment such that a reasonable investor would recognize the need to conduct some investigation" and the investor failed to do so.<sup>193</sup> In the *Bayou* case, for example, one "red flag" might be the lack of an independent auditor if diligent investigation would have revealed the need for one.<sup>194</sup> Already, some commentators have highlighted the potential applicability of the ruling in *Bayou* to Madoff fraud litigation.<sup>195</sup>

Notwithstanding the broad reading of applicable fraudulent conveyance law, however, the law as it stands cannot in most cases return both sets of investors to parity. It cannot, in other words, require every innocent investor to surrender as fraudulent transfers any and all payments received by the investor from the scheme for equitable redistribution among all innocent investors on a pro rata basis, in accordance with the principal amount invested. Such a result is, however, potential-

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190. *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC)*, 396 B.R. 810, 822 (Bankr. S.D.N.Y. 2008).

191. *See id.* at 842-43.

192. *See id.* at 844.

193. *Id.* at 848. More specifically, the court held:

[A] defendant may establish his [good faith] defense [to a fraudulent conveyance claim] if he can prove by a preponderance of the credible *objective evidence* that his request for redemption was in fact the result of a good faith reason other than his knowledge of 'red flags,' even if he was on inquiry notice and did not make inquiry before redeeming.

*Id.* at 849.

194. *See id.* at 850-52; *see also id.* at 846 ("Once on inquiry notice, a transferee's failure to conduct a 'diligent investigation' is fatal to the 'good faith' defense.").

195. *See, e.g.,* Mark Hosenball, *Made Money with Madoff? Don't Count on Keeping It*, NEWSWEEK, Jan. 12, 2009, at 9 (reporting that the KL Gates law firm, which represented the victims in the *Bayou* case, claimed that *Bayou* "provide[s] instructive guidance to [Madoff] investors and other affected parties").

ly achievable with the use of *contractual* clawbacks in the underlying investment contracts.

### C. CONTRACTUAL CLAWBACKS IN PONZI SCHEMES

In examining contractual clawbacks in the context of investment agreements, this Section will consider in turn the function of clawbacks, their structure, and their desirability from both the perspective of the investor and public policy.

#### 1. The Function of Contractual Clawbacks

Contractual clawbacks in investment agreements provide a way of minimizing the risk that any individual investor will be left in the position of a losing investor in the event the investment turns out to be part of a Ponzi scheme. Instead of depending on courts to impose clawback payments made to winning investors at the back end—a remedy whose reach, as discussed above, is generally limited to a payment amount representing the (fictitious) profits<sup>196</sup>—the investor could in theory better protect herself prospectively by including a provision in the investment contract that would claw back all amounts paid out to investors contingent on the fund becoming insolvent as a result of fraud. The provision would also establish that the amounts so recovered would then be distributed to all investors on a pro rata basis.

The contractual clawback effectively eliminates the distinction between winning and losing investors, since all investors would be treated similarly under the provision. The net result is that the risk of fraud in any investment would be more equally allocated among the investors. Such a risk distribution arguably reflects more accurately what the reasonable investor would have expected in the first instance, but which expectation turns out to be false and can be restored post facto only to a limited extent. Clawbacks in investment contracts therefore operate to ensure that investors' expectations concerning risk allocation are not shortchanged.

#### 2. The Structure of Contractual Clawbacks

We believe clawback provisions would, on balance, benefit good faith investors if adopted into the standard boilerplate of investment contracts. Here, we propose, as one example, language for such a clause:

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196. See *supra* note 172 and accompanying text.



In the event of the investment fund becoming insolvent because of fraud, the investor agrees that any payments received by the investor under the fund representing any amount of principal invested may be recovered by an appointed Representative and deposited in a central repository for subsequent redistribution to all investors in amounts pro-rated according to the amount of principal invested by the particular investor.<sup>197</sup>

A potential complication, however, is that there is typically no contractual privity among the investors themselves.<sup>198</sup> Rather, the investment structure usually consists of individual, separate contracts between each investor and the investment fund.<sup>199</sup> Since the contractual clawback would bind only the particular parties to the contract, an investor would be bound under the provision to surrender all funds received without the assurance that other investors would do the same. In essence, the contractual clawback as rendered above would function as a third-party beneficiary contract.<sup>200</sup>

One way of addressing the lack of contractual privity would be to qualify the contractual clawback with a reciprocal clause so that only investors with similar provisions in their investment contracts would be permitted to enforce the clawback.<sup>201</sup>

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197. The contractual clawback is limited to payments representing any amount of the principal invested since any payments in excess of that amount represent fictitious profits and will be treated as fraudulent transfers for redistribution to losing investors and all other creditors. *See supra* notes 172–73 and accompanying text.

198. 13 SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 37:1 (Richard A. Lord ed., West Group, 2000); *cf.* *Cheney v. Powell*, 15 S.E. 750, 751 (Ga. 1892) (holding that privity of contract may exist in the context of fraud if there is conspiracy between parties).

199. 13 WILLISTON, *supra* note 198, § 37:1.

200. *See generally* Anthony Jon Waters, *The Property in the Promise: A Study of the Third Party Beneficiary Rule*, 98 HARV. L. REV. 1109, 1177–1209 (1985) (discussing the evolution of third-party beneficiary contracts since 1964). Under the Restatement approach, for example, a third party may recover if it is an “intended beneficiary” of the contract. *See* RESTATEMENT (SECOND) OF CONTRACTS § 302 (1981). To satisfy this requirement, the third party must show, among other things, that allowing a contract remedy will “effectuate the intention of the parties.” *Id.*

201. An example of a reciprocal provision is the statutory provision regarding an alien’s privilege to sue:

Citizens or subjects of any foreign government which accords to citizens of the United States the right to prosecute claims against their government in its courts may sue the United States in the United States Court of Federal Claims if the subject matter of the suit is otherwise within such court’s jurisdiction.

28 U.S.C. § 2502(a) (2006). An illustration of this statute’s operation can be found in the case of *Henriquez & Gornell, Inc. v. United States* where the court noted that a Panamanian citizen could sue the United States because the “Re-

For example, the sample contractual clawback above might limit the beneficiaries of the subsequent redistribution to investors with contractual clawbacks in their investment contracts, reading as follows:

In the event of the investment fund becoming insolvent because of fraud, the investor agrees that any payments received by the investor under the fund representing any amount of principal invested may be recovered by an appointed Representative and deposited in a central repository for subsequent redistribution among those investors *whose investment contracts contain similarly-rendered clawback provisions* in amounts pro-rated according to the amount of principal invested by the particular investor.

It is, of course, entirely possible that any clawback provision in the particular investment contract is a standard clause in all investment contracts entered into by the investment fund with its investors, so that a clawback would by default be included in all contracts. Indeed, the investment fund would appear to have little incentive to remove such a clawback since the provision reallocates the risk of loss only as among the investors, and has no impact on its bottom line. If, in fact, the contractual clawback becomes a standard provision, the problems arising from the lack of privity would be much diminished, as would the need for reciprocal clawbacks.

### 3. The Desirability of Contractual Clawbacks

Thus far, we have assumed that investors will find contractual clawbacks desirable because they will want a more even distribution of the risk of loss. This may not be true, however, of all investors. Because the winning investor in a situation not involving contractual clawbacks (and who thus gets to keep payments received up to the amount of the principal invested) will nevertheless suffer a comparatively smaller loss than the investor who gets a pro rata distribution as a result of a contractual clawback, there may be investors who would prefer to gamble on the odds of ending up a winning investor and reject such a clawback provision.

It bears noting, however, that the comparative upside is as minimal as the downside is significant—the winning investor at best breaks even and does not get to keep any profits, where-

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public of Panama accords to citizens of the United States the right to prosecute claims against the Republic in its courts. Therefore, under the reciprocal provision of Title 28 U.S.C. 2502 (Alien's Privilege to Sue) plaintiff is entitled to bring its contract claim against the defendant in this court." 180 Ct. Cl. 1040, 1049-50 (1967).

as the losing investor may forgo the entire principal invested. As such, and since it is not possible in general to determine ex ante whether one will be a winning or losing investor, we believe that the rational investor will have an incentive to include a clawback in its investment contract.<sup>202</sup>

Whether investors desire clawbacks is a separate question from whether clawbacks are desirable from a public policy perspective. However, to the extent we agree that equally innocent victims of a fraud should not bear the resulting loss unequally simply because of pure circumstance—a conclusion that courts themselves have reached<sup>203</sup>—the two considerations, and therefore their solutions, converge.

Further, the disparate outcome between winning and losing investors may provide an investor the incentive to delay disclosing any post-investment discovery of fraud at least until the investor recoups his principal. Conversely, because an investor subject to a contractual clawback will generally stand to recover more the earlier the fraud is discovered, the incentive structure is reversed in favor of disclosure at the earliest possible time. Also, winning investors currently have no incentive to be involved in the bankruptcy and indeed may actively avoid participation, thereby potentially depriving the trustee of useful information about the fraud.<sup>204</sup> Indeed, winning investors in the Madoff fraud are apparently being advised to avoid litigation, and “to stay off the radar screen of the trustee who is figuring out how to pursue the Madoff firm’s remaining assets—including potential ‘clawback’ recaptures of purported profits paid to early investors.”<sup>205</sup>

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202. It may be the case that the initial investors in a smaller fund will, in fact, be aware of their status as such, and will not have the incentive to agree to contractual clawbacks. Presumably, however, such investors will constitute a small proportion of the investor population. Also, to the extent that such investors are put on notice of fraudulent behavior with regard to the fund, which may be more likely under these circumstances, all payments made to them may be recoverable as fraudulent transfers under an actual fraud recovery theory since they will be unable to assert a good faith defense. See *supra* notes 146, 168–69 and accompanying text.

203. See, e.g., *supra* notes 182–83 and accompanying text.

204. Cf. Christine Seib, *Madoff Winners Stash Their Profits*, THE AUSTRALIAN, Mar. 16, 2009, [http://www.theaustralian.news.com.au/business/story/0,25192402-5017996,00.html?from=marketwatch\\_rss](http://www.theaustralian.news.com.au/business/story/0,25192402-5017996,00.html?from=marketwatch_rss) (“Investors facing the clawback are confused about whether to submit a claim for compensation from the Securities Investor Protection Corporation . . . Jason Cowart, a partner with Pomerantz, a New York-based class-action specialist, said that clients were ‘deeply concerned’ at the prospect of losing more money in a clawback.”).

205. Martha Neil, *Some Madoff Investors Made Money—and Are Now Ly-*

It may be that the more equitable reallocation of risk resulting from the use of contractual clawbacks results in a generally less vigilant investor since the reallocation reduces the risk of catastrophic loss for any individual investor. Even so, decreased vigilance is arguably an acceptable price for using contractual clawbacks since there is no assurance that maintaining current levels of vigilance would in fact result in earlier discoveries of fraud—witness the SEC's Madoff investigation debacle<sup>206</sup>—whereas under a regime of contractual clawbacks, it is a certainty that when fraud is discovered, all innocent investors will be treated on an equal footing.<sup>207</sup>

### III. A DOCTRINE OF CLAWBACKS

As noted in the introduction, the media and other commentators have used the term “clawback” extensively in the past few months, but in a reflexive way, with no consensus as to what is meant by the term.<sup>208</sup> “Clawback” has been generally used to refer to any action for recoupment of a loss. Meanwhile, “clawback” has taken on narrow meanings for terms of art within specialized corners of legal doctrine. For example, “clawbacks” have been used in venture capital agreements to spread profits and losses among funds,<sup>209</sup> and to describe everything from the effect of federalism on Medicare regulations,<sup>210</sup> to the taxation of real estate investment trusts (REITs) and other investment vehicles, as well as statutory provisions re-

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ing Low, A.B.A. J.L. NEWS NOW, Jan. 23, 2009, [http://abajournal.com/news/some\\_madoff\\_investors\\_made\\_moneyand\\_are\\_now\\_lying\\_low](http://abajournal.com/news/some_madoff_investors_made_moneyand_are_now_lying_low).

206. See *supra* note 133 and accompanying text.

207. See *supra* Part II.C.2.

208. See *supra* note 16 and accompanying text.

209. See, e.g., Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 73–74 (2006) (describing “clawbacks” as a term of art used in venture capital fund contracts to ensure that a venture capitalist “receives no more than her specified percentage of fund profits upon the termination of a fund”).

210. See, e.g., Nicole Huberfeld, *Clear Notice for Conditions on Spending, Unclear Implications for States in Federal Healthcare Programs*, 86 N.C. L. REV. 441, 445 (2008) (“As a result of the new Medicare drug benefit, the Clawback provision . . . [requires] states to pay the federal government . . . .”); Elizabeth A. Weeks, *Cooperative Federalism and Healthcare Reform: The Medicare Part D “Clawback” Example*, 1 ST. LOUIS U. J. HEALTH L. & POL’Y 79, 82 (2007) (describing clawbacks in the healthcare context as a federal provision that conditions states’ receipt of Medicare funds on payments to the federal government).

garding the extraterritorial application of a nation's laws.<sup>211</sup> Finally, in electronic discovery, a "clawback agreement" also refers to an instance where the parties to a lawsuit make a prospective agreement that any information inadvertently and inappropriately disclosed during the discovery process will be returned.<sup>212</sup>

Notwithstanding this plethora of references, the standard contracts treatise contains nary a section, never mind a chapter, on the elusive "clawback."<sup>213</sup> And even though the term is not of recent provenance, there is little sign of any consensus on "clawback doctrine," since the term has been subject to neither rigorous analytical scrutiny nor definition and exposition. Thus, the challenge for this Article in proposing a doctrine of clawbacks is to determine where one might find clawbacks in a contracts treatise, what the chapter on clawbacks would say, and how it would relate to other established bodies of contract doctrine.

We begin the exercise by identifying what appear to be two distinctive features common to many applications of the term "clawback." The first feature, adumbrated in its very name, is that a clawback is a recovery device that is potentially draconian but justifiable under the triggering circumstances because of an inherent unfairness that would otherwise prevail. The second feature, as evidenced in our examination of executive compensation and Ponzi schemes above,<sup>214</sup> is that clawbacks

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211. See, e.g., Austen Parrish, *The Effects Test: Extraterritoriality's Fifth Business*, 61 VAND. L. REV. 1455, 1492 n.193 (2008) (describing clawback statutes that enable a defendant who paid multiple damages in a foreign country to recover the multiple portion of those damages from the plaintiff).

212. See, e.g., Shira A. Scheindlin & Jonathan M. Redgrave, *Special Masters and E-Discovery: The Intersection of Two Recent Revisions to the Federal Rules of Civil Procedure*, 30 CARDOZO L. REV. 347, 357 (2008) (defining a clawback in context of discovery as an "agreement regarding a procedure for retrieving privileged information that has been inadvertently produced in the course of discovery").

213. Although it is always difficult to find a citation for a negative proposition like this one, the authors did a quick survey of the contracts casebooks in their respective offices, including: RANDY E. BARNETT, *CONTRACTS: CASES AND DOCTRINE* (3d ed. 2008); BRIAN A. BLUM & AMY C. BUSHAW, *CONTRACTS: CASES, DISCUSSIONS, AND PROBLEMS* (2d ed. 2008); and E. ALLEN FARNSWORTH ET AL., *CONTRACTS: CASES AND MATERIALS* (7th ed. 2008) and did not find chapters or significant discussion of anything related to clawbacks in the books. The authors also consulted their textbooks on business associations and corporate law and did not find the term discussed there either.

214. See *supra* Parts I.B–C, II.B–C.

are generally more effective when they operate prospectively rather than retroactively.

Accordingly, in constructing a framework within which to analyze clawbacks, we advance below a definition that we believe not only takes account of these features, but that encompasses many of the term's current applications. Relying on that definition, we then examine the nature of clawbacks, explaining their function and necessity, and also why clawbacks are more effective when employed prospectively rather than retroactively. We then go on to examine the implications of such clawback provisions on other areas of contract doctrine. We conclude this Section by discussing the relative merits and drawbacks of bottom-up versus top-down solutions, and the role of government in mandating prospective clawbacks in certain situations.

#### A. A PROPOSED DEFINITION

To lay a foundation for the doctrine, we propose that a clawback be defined as a right to, or action for, the restitution of unfair enrichment that is otherwise justified or permitted under prevailing applicable law. As used here, the term "unfair enrichment" shares certain features with, but also appears to vary in other respects from, the traditional concept of unjust enrichment. The traditional concept of unjust enrichment focuses on disgorgement from the breaching party.<sup>215</sup> In the words of one leading commentator, the underlying premise of unjust enrichment is that "gains produced through another's loss are unjust and should be restored."<sup>216</sup>

Unfair enrichment, like unjust enrichment, can apply to those situations where the person unfairly enriched is not responsible for the underlying wrongdoing or event leading to the unfair enrichment. For example, the innocent winning investor in a Ponzi scheme who is not responsible for the fraud is nevertheless subject to the clawback of fraudulent conveyance laws.<sup>217</sup> To take an example from the executive compensation context, an AIG executive who did not directly work on mortgage-backed securities or credit default swaps but received a

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215. See, e.g., JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 599–605 (4th ed. 1998).

216. John P. Dawson, *The Self-Serving Intermeddler*, 87 HARV. L. REV. 1409, 1409 (1974).

217. See *supra* Part II.A.

bonus would still have to surrender ninety percent of the bonus if the pending bill passes.<sup>218</sup>

Unfair enrichment also, however, extends to those situations where the enrichment cannot readily be said to be unjust (per unjust enrichment principles) insofar as the person unfairly enriched has a preexisting legal right to payment.<sup>219</sup> In essence, clawbacks target certain inequities that are not wholly legally cognizable because they are in tension with independent legal rights that have already justified or allowed for such inequities to exist in the first place. And thus, while it is unfair that the losing investor in a Ponzi scheme will suffer a comparatively greater loss than the winning investor when both are equally blameless, recognizing that inequity is in tension with the fact that the winning investor has a contractual right to the payments received as well as a restitutionary claim for the principal investment.<sup>220</sup> Similarly, it seems unfair that an executive at AIG could walk away with a bonus when the company he had a responsibility to assist is failing. Nonetheless, under existing law, making an equitable claim under these circumstances is problematic as it must tackle the executive's original contractual claim to the bonus.<sup>221</sup>

It may be that, as sketched out above, unfair enrichment could be regarded as a variant, albeit an unfamiliar one, of unjust enrichment.<sup>222</sup> Regardless, we think it is useful here to de-

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218. See *supra* notes 69–76 and accompanying text.

219. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. b (Discussion Draft 2000) (“Unjustified enrichment is enrichment that lacks an adequate legal basis: it results from a transfer that the law treats as ineffective to work a conclusive alteration in ownership rights.”).

220. See *supra* Part II.A.

221. See *supra* notes 69–76 and accompanying text.

222. One might argue, for instance, that unfair enrichment is consistent with unjust enrichment as interpreted by Warren Seavey and Austin Scott, the reporters of the *Restatement (first) of Restitution*. They cautioned that restitution law responds only imperfectly to the basic premise of unjust enrichment and that situations in which “it is not possible to be just to one without being unjust to the other” prevent the perfect embodiment of “the fundamental conception of restitution” into rule form. Warren A. Seavey & Austin W. Scott, *Restitution*, 54 L.Q. REV. 29, 35–37 (1938); see also LORD GOFF OF CHIEVELEY & GARETH JONES, *THE LAW OF RESTITUTION* 13 (Gareth Jones ed., 6th ed. 2007) (noting that unjust enrichment is a “principle of justice which the law recognizes and gives effect to in a wide variety of claims”). Alternatively, one might paint broader strokes by postulating, as Peter Linzer does, that the prevention of “unjust impoverishment” should serve as a source for applying “rough justice” in individual cases when normally sound rules of promissory estoppel and unjust enrichment produce unsatisfactory results. Peter Linzer, *Rough Justice: A Theory of Restitution and Reliance, Contracts and Torts*,

signate the concept separately to delineate those features of clawbacks that not only identify them but also explain their nature.

## B. THE NATURE OF CLAWBACKS

As defined above, a clawback addresses inequities that cannot easily be resolved by existing remedies under the law because of countervailing legal rights independently supporting such inequities.<sup>223</sup> Accordingly, absent the clawback, the unfair enrichment will stand. Although the lack of legal remedies ordinarily connotes the absence of a cognizable legal wrong, such a conclusion does not sit well in situations involving unfair enrichment, and appears to be out of step with prevailing notions of fairness. To the extent we think that these particular notions of fairness should be honored—that these are inequitable situations that need to be redressed notwithstanding the countervailing legal rights involved—we would have to look to clawbacks to override such countervailing rights so as to allow for restitution of the unfair enrichment.

For example, although an individual AIG executive may be blameless and have otherwise valid contractual rights to a bonus, payment of the bonus is unfair because bonuses should not be decoupled from a company's performance, particularly where taxpayer money is involved. We thus have to turn to a retroactive clawback to override the contractual rights in this situation in order to prevent unfair enrichment of the executive.

Thus, clawbacks function to bridge the gap in remedies under prevailing law for addressing unfair enrichment, or perhaps more accurately, they function to manage a claim of right preventing the restitution of an unfairly conferred benefit. Analyzed in these terms, we can now explain why *prospective* clawbacks are generally more effective than retroactive clawbacks. Prospective clawbacks are those clawbacks that are introduced before the claim of right to the benefit or enrichment has arisen.<sup>224</sup> For instance, some companies, like Dell, are prospectively writing provisions into their executive compensation con-

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2001 WIS. L. REV. 695, 764. *Contra* HANOCH DAGAN, THE LAW AND ETHICS OF RESTITUTION 13 (2004) (stating that Linzer's position "is indefensible because . . . '[t]here is nothing both unique to restitution and common to all subjects of restitution that justifies a greater disregard of rules than judges would countenance in other areas of law'" (citation omitted)).

223. See *supra* Part III.A.

224. See *supra* Part I.C.1.



tracts that would recover or cancel bonus awards in the event of restatement of financial results.<sup>225</sup> In contrast, retroactive clawbacks are those clawbacks that, similar to the proposed ninety percent tax on bonuses, are imposed after the contractual right to the bonuses has arisen and the benefits have been conferred.<sup>226</sup>

Our earlier examination of clawbacks in the context of executive compensation and Ponzi schemes indicated that the use of prospective clawbacks—clawbacks written directly into the original contract—was preferable to and more effective than the use of retroactive clawbacks—statutory provisions that retroactively tax a bonus, for example, or fraudulent conveyance laws.<sup>227</sup> The reason for this conclusion lies in the different ways these two approaches manage legal impediments that would otherwise prevent the restitution of unfair enrichment.

As defined above, clawbacks address unfair enrichment that is otherwise justified or permitted under prevailing applicable law. Since such prevailing applicable law justifies or allows for the inequity at issue, any efforts to cure the inequity *retroactively* have to confront the particular legal rights that make the inequity possible. By contrast, *prospective* efforts to prevent the inequity avoid such legal confrontations to the extent that they remove or modify the nature of the rights at issue from their inception. In this way, there is little or no legal impediment that would prevent the restitution of any unfair enrichment.

For example, in the context of Ponzi schemes, while the retroactive clawback of fraudulent conveyance laws is in tension with the winning investor's contractual and restitutionary claims,<sup>228</sup> such tension is not present when employing prospective contractual clawbacks. If there is a prospective clawback provision in the original contract, the winning investor no longer has those contractual and restitutionary claims under specified "unfair enrichment" circumstances as established by the clawback provision in the investor agreement.<sup>229</sup> Likewise, although we could try to implement retroactive clawbacks like

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225. See *infra* Appendix, Part C.1–3 (providing examples of various clawback provisions in executive compensation contracts triggered by a material restatement of financial results).

226. See *supra* note 69 and accompanying text.

227. See *supra* Part II.A.

228. See *id.*

229. See *supra* Part II.C.

the pending tax bill to attempt to recover bonus payments made to AIG executives, such attempts are problematic because they must contend with existing contractual rights to such bonuses, not to mention the concomitant constitutional rights involved.<sup>230</sup> Introducing prospective clawbacks, however, will mean that such contractual rights are modified automatically under the specified circumstances of unfair enrichment to allow for the recovery of the unfair restitution as represented by the bonuses.<sup>231</sup>

Thus, the very nature of clawbacks indicates that prospective rather than retroactive clawbacks will generally prove to be the more effective tool for addressing the unfair enrichment at issue. So far, this Section has concentrated on defining the term "clawback" and argued that prospective clawbacks will be a far more effective way of addressing the various unfair enrichment concerns that arise in executive compensation and Ponzi schemes. We turn in the next Section to a slightly different question—what impact would clawback provisions have on other concepts within contract law doctrine?

### C. IMPLICATIONS OF CLAWBACKS FOR CONTRACT DOCTRINE

#### 1. Reconciling the Doctrine

Clawback provisions could be categorized in varying ways within existing contract doctrine. One such doctrinal home for clawbacks would be the realm of conditions. According to the *Restatement (Second) of Contracts*, a condition only refers to a contract that already exists.<sup>232</sup> Further, the *Restatement* limits a condition to an event that must occur before a duty of performance arises.<sup>233</sup> A prior common law tradition did recognize, however, "an event that extinguishes a duty that has already arisen," in the form of a "condition subsequent."<sup>234</sup> While the *Restatement* has eliminated conditions subsequent and refers only to "conditions," this terminology and the analytical frame-

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230. See *supra* note 75 and accompanying text.

231. See *supra* Part I.C.

232. RESTATEMENT (SECOND) OF CONTRACTS § 224 cmt. c (1979) ("In order for an event to be a condition, it must qualify a duty under an existing contract.").

233. *Id.* § 224 ("A condition is an event not certain to occur . . . before performance under a contract becomes due.").

234. E. ALLEN FARNSWORTH, CONTRACTS 523–25 (3d ed. 1999).

work on which it is based may be useful for our present purposes.<sup>235</sup>

To illustrate how a clawback provision could be categorized as a condition subsequent, consider an example from the executive compensation context. A contract between the corporation and the executives might provide a certain level of bonus. The obligation to pay out the bonus would be conditioned on the company's stock price reaching a particular level. Reaching that performance goal would therefore be a condition precedent to payment of the bonus. Once that performance goal has been reached, a legal obligation to pay the bonus attaches. However, let us also assume that the original contract additionally included a clawback provision that is triggered in the event that the financial benchmarks were later found to have been reached through fraudulent accounting, in the form of a material restatement of financial results.<sup>236</sup> Such a clawback provision would then operate as a condition subsequent. Even though the legal duty to pay the bonus had technically arisen when the stock price was reached, it would be extinguished by the "triggering" of the clawback (i.e., the restatement of financial results).

Another way to think about the role of clawback provisions within contract doctrine would be to see them as a form of stipulated damages. Parties may agree in advance to an amount of money payable in the event of breach of contract. In essence, this allows the parties to rewrite the default rules for contract damages by prior agreement.<sup>237</sup> An important limitation on stipulated damages, however, is that they cannot be so large that they have an "*in terrorem* effect," lest they be classified as a penalty.<sup>238</sup> If a clause is "condemned as a penalty," a court will hold that the provision is unenforceable.<sup>239</sup>

One way this view of clawbacks as stipulated damages might play out can be illustrated by the example of a contractual clawback provision that is triggered in the event of execu-

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235. *Id.* at 523.

236. *See, e.g., infra* Appendix (categorizing various clawback provisions in executive compensation contracts based on triggering events, one of which might be material restatement of financial results).

237. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 (1979) ("Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.").

238. FARNSWORTH, *supra* note 234, at 841.

239. *Id.* at 843.

tive misconduct.<sup>240</sup> Let us assume in this instance that performance benchmarks are met, and the bonus is paid. Unfortunately, in prior weeks, the executive had gambled millions of dollars in company money away in Las Vegas—a result that would doubtless be deemed “misconduct.” At that point, the misconduct creates a breach and requires activation of the clawback provision to recover the bonus that had been paid. In this example, the stipulated damages amount is the amount of the bonus.<sup>241</sup> If this result is too harsh or draconian, it may be challenged and held unenforceable in the same way that a penalty clause might be challenged and invalidated under the standard doctrinal dichotomy of liquidated damages versus penalties.<sup>242</sup>

Ultimately, clawback provisions could have an effect on many of the other significant doctrinal areas that concern the allocation of risk within contracts. Some of the more salient areas that might be affected would be conditions more generally, as well as defenses—including mistake,<sup>243</sup> impracticability,<sup>244</sup> and frustration of purpose<sup>245</sup>—the application of which would all depend on notions of allocation of risk.

## 2. Relational Contract Theory and Executive Compensation

Clawback provisions may also impact contract doctrine on a more theoretical level. Such provisions in the context of executive compensation lend support to relational contract theory as opposed to the classical model of contracting. The classical model views the behavior of contracting as involving a series of discrete contracts between rational actors in a competitive marketplace who employ contracts as a way to allocate risks.<sup>246</sup>

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240. See, e.g., *infra* Appendix, Part B.1–2 (describing clawback provisions in executive compensation contracts based on the triggering event of executive fraud or misconduct).

241. Of course, one could argue that the company could turn around and sue its agent for fraud—and if the company was unwilling to do so, a shareholder could bring a derivative action to force the company to act. Bringing a claim of fraud, however, which requires pleading with particularity, is more difficult than a straight contract claim. See FED. R. CIV. P. 9(a) (“In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.”).

242. See FARNSWORTH, *supra* note 234, at 843.

243. See RESTATEMENT (SECOND) OF CONTRACTS §§ 151–158 (1979).

244. See *id.* §§ 261–272.

245. See *id.*

246. See, e.g., Melvin A. Eisenberg, *Why There Is No Law of Relational Contracts*, 94 NW. U. L. REV. 805, 805 (2000) (stating that classical contract

Under this model, the contract may specify which party bears the risk of the occurrence (or nonoccurrence) of particular events, and sophisticated parties bargain in order to place a risk upon that party that is the least-cost avoider.<sup>247</sup>

In contrast, relational contract theory, as described by Professors Ian Macneil<sup>248</sup> and Stewart Macaulay,<sup>249</sup> seeks to put the contracting parties' interactions into a larger social context. Instead of seeing contracts as one-off discrete transactions, relational theory describes patterns of reciprocal behavior, often over a period of years, between repeat players.<sup>250</sup>

Clawback provisions in executive compensation contracts, through their very structure, rule out the possibility of a short-term relationship. Because certain events that could occur in the future may trigger the reclamation of the benefit conferred, a contract with a clawback provision cannot be a one-off transaction. A contract with a prospective clawback term thus serves to link the parties to each other and incentivizes executives to perform over longer periods of time.

From these questions of contract doctrine, we turn now to a final question, which is how these prospective clawback measures might be implemented. In addressing this question, the following Section considers whether their adoption will be wholly voluntary or alternatively achieved with the assistance of the legislature, administrative agencies, or courts.

#### D. BOTTOM-UP OR TOP-DOWN APPROACHES TO CLAWBACKS?

In the aftermath of the financial crisis, renewed calls for

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theory was based on "a paradigm of bargains made between strangers transacting on a perfect market" and "a rational-actor model of psychology").

247. For a thorough treatment of the classical model of contract, as well as other theoretical perspectives on contracts, see Kojo Yelpaala, *Legal Consciousness and Contractual Obligations*, 39 MCGEORGE L. REV. 193, 209–13 (2008).

248. See, e.g., Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 881 (2000); Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 484.

249. See, e.g., Stewart Macaulay, *Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian MacNeil and Lisa Bernstein*, 94 NW. U. L. REV. 775, 792–93 (2000).

250. Cf. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 779–89 (9th Cir. 1981) (finding "course of trade" important in the evaluation of a long-term contractual relationship between parties who acted as functional partners); *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3, 6–9 (4th Cir. 1971) (finding "course of dealing" important in the evaluation of contract terms where Royster had once been a purchaser and then became a seller).

government regulation have already ensued. Professor Joseph Grundfest analogizes the reactive pattern of lawmaking in the securities area to the evolutionary biology theory of punctuated equilibrium.<sup>251</sup> In evolutionary biology, sudden and drastic changes take place in response to “dramatic and identifiable events.”<sup>252</sup> Grundfest likens the Great Depression and the Enron failure to extreme events that forced securities law to evolve at a rapid pace.<sup>253</sup> In the case of the Great Depression, the regulatory response to the stock market crash created our system of public reporting and disclosure.<sup>254</sup> And in response to several massive accounting frauds at Enron and WorldCom, Congress passed the Sarbanes-Oxley Act, separating “federal securities law from state corporate law” and creating “an entirely new structure for the governance of the accounting profession.”<sup>255</sup>

Certainly, the financial crisis of the fall of 2008 is of such magnitude that one wonders whether a top-down regulatory solution is needed in order to prevent the vicissitudes of the financial cycle—both those gyrations that are irrationally exuberant as well as the inevitable troughs. At the same time, we should not fall into the trap of only regulating in response to scandal.<sup>256</sup> Solutions and policies should be contemplated and analyzed *before* problems arise. Analysts have not had time yet to react to the financial crisis—or to think through fully any of its root causes. For now, it is enough to say that we tend to be in more of a reactive position in responding to financial crises generally,<sup>257</sup> not only in the current situation.

One alternative that we have discussed throughout this Article is to write clawback provisions directly into contracts on a prospective basis. Attorneys for investors have been trying to

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251. See Joseph Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J. L. BUS. & FIN. 1, 1–2 (2002).

252. *Id.*

253. See *id.*

254. See *id.* at 1.

255. *Id.* at 2.

256. See Rosen, *supra* note 50, at 2940 (“Corporate scandals may indicate a need for reform, but poor, ill-considered reform can easily lead to further frustration for the scandals’ victims.”).

257. See, e.g., *President-Elect Obama Announces Mary Schapiro as Head of Securities and Exchange Commission*, WASH. POST, Dec. 18, 2008, [http://www.washingtonpost.com/wpdyn/content/article/2008/12/18/AR2008121802394\\_pf.html](http://www.washingtonpost.com/wpdyn/content/article/2008/12/18/AR2008121802394_pf.html) (reporting President Obama’s statement that “what will be just as important to our long-term economic stability is a 21st-century regulatory framework to ensure that a crisis like this can never happen again”).

cobble together these types of clawback remedies *retroactively* based on equitable principles.<sup>258</sup> Obviously, it would be easier for attorneys to implement these types of remedies if they were clearly written *prospectively* into investment contracts, in the context of hedge funds, or into employment contracts, in the context of corporate management. This is more of a bottom-up approach to reform,<sup>259</sup> with incremental changes in individual contracts, which then generate a body of law surrounding clawback provisions, their substance, their interpretation, and their enforcement.

In contract law, specialized clauses like the clawback provisions we discuss here serve important functions. The more a particular clause is used, the more likely it is to be included in standard boilerplate, and to have a body of doctrine and particular modes of related judicial interpretation.<sup>260</sup> One example would be the humble (yet heroic) force majeure clause, which allocates risk between the parties upon the instance of a catastrophic event.<sup>261</sup> Major casebooks include a discussion of force majeure clauses, normally as part of their discussion of frustration of purpose or commercial impracticability.<sup>262</sup> Other examples of such specialized provisions include merger and integration clauses (normally included in discussion of the parol evidence rule),<sup>263</sup> indemnification clauses,<sup>264</sup> and provisions re-

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258. See *supra* Part III.B.

259. See generally Jeffrey J. Rachlinski, *Bottom-Up Versus Top-Down Lawmaking*, 73 U. CHI. L. REV. 933, 933 (2006) ("Democratic legal systems make law in one of two ways: by abstracting general principles from the decisions made in individual cases (from the bottom up); or by declaring general principles through a centralized authority that are to be applied in individual cases (from the top down)."); Frederick Schauer, *Do Cases Make Bad Law?*, 73 U. CHI. L. REV. 883, 891 (2006) (observing the difference between case-based and non-case-based rulemakers).

260. See Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 MICH. L. REV. 1075, 1078 (2006) (observing how contract terms "become boilerplate either because they are widely copied or because they are used repeatedly by the drafter or its client").

261. See, e.g., *Phillips P.R. Core, Inc. v. Tradax Petroleum Ltd.*, 782 F.2d 314, 319–20 (2d Cir. 1985) ("[T]he basic purpose of force majeure clauses . . . is . . . to relieve a party from its contractual duties when its performance has been prevented by a force beyond its control or when the purpose of the contract has been frustrated.").

262. See, e.g., FARNSWORTH, *supra* note 234, at 642–44.

263. See, e.g., *id.* at 436.

264. See, e.g., *id.* at 373.

lating to warranties.<sup>265</sup> In all of these instances, the clauses acquire particular meanings as they become more commonplace and routine.

It may be that investors will begin demanding clawback protections independent of any regulation. On the other hand, we have seen all too frequently the principal-agent problem manifesting itself in the corporate context.<sup>266</sup> The gap between the shareholders and the board of directors can, all too often, result in a lack of accountability for the board and the managers of the publicly traded company.<sup>267</sup> Between the public outcry over executive bonuses, and the motivation this proxy season to write clawbacks into executive compensation contracts going forward, it is entirely possible that there will be sufficient momentum present to solve the problem.

It is also possible that legislative or administrative action by the SEC is required in order to ensure the inclusion of clawbacks in executive compensation arrangements. This is not an unusual proposal; there are many laws (securities-related and otherwise) that mandate particular disclosures, or specific contractual language. For example, mandatory disclosures are required in certain real estate transactions.<sup>268</sup> But one need not even stray that far from the corporate context in order to find such examples of mandatory disclosures. For example, contracts for the sale of stock in a private placement must disclose particular limitations on the resale of the securities.<sup>269</sup> At this point, these provisions are well-accepted, and indeed expected. With so many disclosures already part of the landscape of contract in the securities arena, mandating an additional set of prospective contract terms concerning clawback provisions is eminently achievable.

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265. See, e.g., U.C.C. § 2-314 (2000) (addressing the creation of express warranties in the sale of goods as governed under the Uniform Commercial Code).

266. See BEBCHUK & FRIED, *supra* note 4, at 15–17 (discussing the emergence of the agency problem in the corporate context).

267. See *id.*

268. 9 THOMPSON ON REAL PROPERTY § 78.08(b)(3) (David A. Thomas ed., 2d ed. 1999) (describing a California law that mandates disclosures in real property as to the condition of the land, the location of adjacent airports, and any provisions for public utilities).

269. See SEC Private Resales of Securities to Institutions Rule, 17 C.F.R. § 230.144A (2009).



## CONCLUSION

This Article has described, in detail, the use of contractual clawbacks in two different scenarios—executive compensation and Ponzi schemes. In both of these situations, we have analyzed the gap in the remedies currently available and remarked that the gap leads to a continuing problem of unfair enrichment. As we have described, writing clawbacks prospectively and directly into contracts can provide a ready avenue for recovery. In the context of executive compensation, prospective clawbacks force executives to align their interests with that of the long-term growth of the company. In the context of Ponzi schemes, such clawbacks present an opportunity to equalize the final position of winning and losing investors. In tandem, these remedies provide an important way of prospectively changing the legal landscape to further the protection of shareholders and investors.

## APPENDIX: CATEGORIES OF CLAWBACKS IN EXECUTIVE COMPENSATION CONTRACTS

The following is a categorization of clawback provisions regarding executive compensation, which are triggered in the event of employee bad faith, misconduct or fraud, or a restatement of financial results. These exemplars of clawbacks have been culled from the filings of publicly traded companies. Compensation arrangements are typically disclosed in a company's Compensation Discussion and Analysis (CDA), a portion of the company's definitive proxy statement (Form 14A-DEF), as filed with the SEC. While the content of a clawback may vary widely with the language of any particular contract, these categories seem to reflect the most common triggering events for recoupment. The first category, bad faith, would likely be ineffectual, while the last category, which would allow for a clawback in the event of a material financial restatement, would probably have the most impact.

### A. BAD FAITH CONDUCT

1. McKesson Corp., Definitive Proxy Statement (Form DEF 14A), at 32 (June 23, 2008).

*Clawback Policy.* As described in the Company's standard award documentation, the Compensation Committee may seek to recoup any economic gains from equity grants from any employee who engages in conduct which is not in good faith and which disrupts, damages, impairs or interferes with the business, reputation or employees of the Company or its affiliates.

2. Ford Motor Corp., Definitive Proxy Statement (Form DEF 14A), at 71–72 (April 4, 2008).

The Plan has certain conditions which must be met prior to the distribution of any award in order for a participant to receive an award following termination of employment. These conditions include continuing employment with the Company or a subsidiary or, if termination was for a reason other than death, being available to consult and supply information to the Company. In addition, the participant must refrain from competitive activity, unless the Company approves the activity. A participant also may forfeit an

award, including deferred amounts, for conduct contrary to the best interests of the Company.

## B. FRAUD OR MISCONDUCT

### 1. General Motors Corp., Definitive Proxy Statement (Form DEF 14A), at 35 (April 25, 2008).

In October 2006, the GM Board adopted and announced a policy regarding the recoupment of unearned compensation, applicable to incentive compensation paid to executive officers after January 1, 2007 and unvested portions of awards previously granted, in situations involving financial restatement due to employee fraud, negligence, or intentional misconduct. In conjunction with this, the Committee charter was modified to reflect the new policy and the revised charter and policy were published on GM's Web site. In addition, we added provisions to all executive incentive and deferred compensation plans to reference Board policies affecting compensation, and require that the compensation of all executives covered by this policy be subject to this recoupment clause.

### 2. American Express Co., Definitive Proxy Statement (Form DEF 14A), at 32 (March 14, 2008).

*Policy Regarding Recoupment of Incentive Compensation.* To protect the shareholders' interests, we have a policy pursuant to which we will, to the extent practicable, seek to recover performance-based compensation from any executive officer and certain other members of senior management in those circumstances where (i) the payment of such compensation was based on the achievement of financial results that were subsequently the subject of a restatement, (ii) in the Board's view the employee engaged in fraud or misconduct that caused or partially caused the need for the restatement, and (iii) a smaller or no payment would have been made to the employee based upon the restated financial results.

*Detrimental Conduct.* To help protect our competitive position, we have a "detrimental conduct" policy, covering approximately 540 executives (including the

NEOs). Each covered executive is required to sign an agreement that requires him or her, among other provisions, to forfeit the pre-tax proceeds from some or all of his or her compensation received under the 1998 Plan and the 2007 Plan, including RSAs (and dividends paid), NQSOs, RSUs (and dividend equivalents paid), PGs awarded under either plan and, in the case of executive officers, all of his or her AIAs that were received up to two years prior to employment termination if he or she engages in conduct that is detrimental to the Company following employment termination. Detrimental conduct includes, for example, working for certain competitors, soliciting our customers or employees, or disclosing our confidential information. The detrimental conduct policy is in addition to the obligations arising under our Code of Conduct.

#### C. RESTATEMENT OF FINANCIAL RESULTS

1. Cisco Systems, Inc., Definitive Proxy Statement (Form DEF 14A), at 28 (September 25, 2008).

Following the Compensation Committee's recommendation in March 2008, the Board of Directors adopted a recoupment policy for cash incentive awards paid to executive officers under Cisco's annual cash incentive plan, the EIP. In the event that there were a restatement of incorrect financial results, this policy would enable the Compensation Committee, if it determined appropriate and subject to applicable laws, to seek reimbursement of the incremental portion of EIP awards paid to executive officers in excess of the awards that would have been paid based on the restated financial results. Cisco's variable cash incentive and long-term, equity-based incentive award plans also generally provide for forfeiture if a named executive officer participates in activities detrimental to Cisco or is terminated for misconduct. Additionally, consistent with statutory requirements, including the Sarbanes-Oxley Act of 2002, and the principles of responsible oversight, and depending upon the specific facts and circumstances of each situation, the Compensation Committee would review all performance-based compensation where a restatement of financial results for

a prior performance period could affect the factors determining payment of an incentive award.

2. Dell Inc., Definitive Proxy Statement (Form DEF 14A), at 71–72 (June 2, 2008).

*Recoupment Policy for Performance Based Compensation.* If Dell restates its reported financial results, the Board of Directors will review the bonus and other awards made to the executive officers based on financial results during the period subject to the restatement, and to the extent practicable, Dell will recover or cancel any such awards based on having met or exceeded performance targets that would not have been met under the restated financial results.

3. Exxon Mobile Corp., Definitive Proxy Statement (Form DEF 14A), at 32 (April 10, 2008).

Should the Corporation's reported financial or operating results be subject to a material negative restatement within five years, the Board would seek to obtain from each executive officer an amount corresponding to any incentive award or portion thereof that the Board determines would not have been granted or paid had the Corporation's results as originally reported been equal to the Corporation's results as subsequently restated.